

*In the opinion of Bond Counsel to the State as described herein, under existing statutes and court decisions and assuming continuing compliance with certain tax covenants, (a) interest on the Offered Veterans G.O. Bonds (i) is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the "Code") and (ii) is exempt from State of California personal income taxes, (b) interest on the Series CC Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations, and (c) interest on the Series CD Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code. See "TAX MATTERS" herein.*

**\$359,160,000**

**STATE OF CALIFORNIA**

**VETERANS GENERAL OBLIGATION BONDS**

**\$155,350,000 Series CC (Non-AMT)**

**\$203,810,000 Series CD (AMT)**

**Dated: Date of Delivery**

**Due: As shown on the inside cover page**

This offering consists of veterans general obligation bonds listed above (the "Offered Veterans G.O. Bonds") authorized by the voters of the State of California (the "State"). The Offered Veterans G.O. Bonds will mature in the years and bear interest at the rates set forth on the inside cover page hereof.

Interest is payable on June 1 and December 1 of each year, commencing June 1, 2007. The Offered Veterans G.O. Bonds may be purchased in book-entry form only, in the principal amount of \$5,000 or any integral multiples thereof. See APPENDIX C — "DTC AND THE BOOK-ENTRY SYSTEM." The Offered Veterans G.O. Bonds are subject to redemption prior to maturity, including redemption at par. See "THE OFFERED VETERANS G.O. BONDS — Redemption."

The Offered Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State are pledged. Principal of, premium, if any, and interest on all State general obligation bonds, including the Offered Veterans G.O. Bonds, are payable from any moneys in the General Fund of the State, subject only to the prior application of such moneys to the support of the public school systems and public institutions of higher education. State law requires that funds equal to debt service on the Offered Veterans G.O. Bonds be transferred to the General Fund from the Veterans Farm and Home Building Fund of 1943. See "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS — Security for and Sources of Payment of Veterans G.O. Bonds."

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed investment decision.

*The Offered Veterans G.O. Bonds are offered when, as and if issued and received by the initial purchaser, subject to certain conditions, including the receipt of certain legal opinions of the Honorable Bill Lockyer, Attorney General of the State of California, and of Hawkins Delafield & Wood LLP, Bond Counsel to the State. In connection with the issuance of the Offered Veterans G.O. Bonds, Gardner Underwood & Bacon LLC and Public Resources Advisory Group have served as Co-Financial Advisors, Quateman LLP has served as Disclosure Counsel to the State, and Orrick, Herrington & Sutcliffe LLP has served as Disclosure Counsel to the State regarding Appendix A. The Offered Veterans G.O. Bonds will be available for delivery on or about November 21, 2006.*

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**HONORABLE PHILIP ANGELIDES**  
**Treasurer of the State of California**

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**The Offered Veterans G.O. Bonds were sold at competitive bid on November 9, 2006.**  
**Interest rates have been set by the successful bidders.**

**\$359,160,000**  
**STATE OF CALIFORNIA**  
**VETERANS GENERAL OBLIGATION BONDS**

**\$155,350,000 Series CC (Non-AMT)**  
**(Base CUSIP<sup>†</sup> No.: 13062)**

**MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND CUSIPS<sup>†</sup>**

<u>Maturity Date</u> <u>(December 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>CUSIP<sup>†</sup></u>	<u>Maturity Date</u> <u>(December 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>CUSIP<sup>†</sup></u>
2014	\$ 550,000	3.875%	TQK3	2018	\$ 815,000	4.125%	TQP2
2015	605,000	4.000	TQL1	2019	885,000	4.150	TQQ0
2016	775,000	4.050	TQM9	2020	970,000	4.200	TQR8
2017	840,000	4.100	TQN7				

\$1,250,000 4.250% Series CC Term Bond Due December 1, 2023, CUSIP<sup>†</sup> TQS6  
\$14,555,000 4.375% Series CC Term Bond Due December 1, 2030, CUSIP<sup>†</sup> TQT4  
\$26,535,000 4.500% Series CC Term Bond Due December 1, 2033, CUSIP<sup>†</sup> TQU1  
\$57,165,000 4.500% Series CC Term Bond Due December 1, 2037, CUSIP<sup>†</sup> TQV9  
\$50,405,000 4.600% Series CC Term Bond Due December 1, 2040, CUSIP<sup>†</sup> TQW7

**\$203,810,000 Series CD (AMT)**  
**(Base CUSIP<sup>†</sup> No.: 13062)**

**MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND CUSIPS<sup>†</sup>**

<u>Maturity Date</u> <u>(December 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>CUSIP<sup>†</sup></u>	<u>Maturity Date</u> <u>(December 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>CUSIP<sup>†</sup></u>
2019	\$ 9,825,000	4.300%	TQX5	2021	\$ 10,595,000	4.375%	TQZ0
2020	10,005,000	4.350	TQY3	2022	11,225,000	4.400	TRA4

\$23,790,000 4.450% Series CD Term Bond Due December 1, 2024, CUSIP<sup>†</sup> TRB2  
\$29,200,000 4.500% Series CD Term Bond Due December 1, 2026, CUSIP<sup>†</sup> TRC0  
\$52,130,000 4.550% Series CD Term Bond Due December 1, 2029, CUSIP<sup>†</sup> TRD8  
\$57,040,000 4.600% Series CD Term Bond Due December 1, 2032, CUSIP<sup>†</sup> TRE6

**Price of all Offered Veterans G.O. Bonds: 100%**

<sup>†</sup> CUSIP is a registered trademark of American Bankers Association. CUSIP data herein provided is provided by Standard & Poor's CUSIP Service Bureau, a division of The McGraw-Hill Companies, Inc. CUSIP data herein is set forth for convenience of reference only. The State assumes no responsibility for the accuracy of such data.

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Copies of this Official Statement may be obtained from:

**HONORABLE PHILIP ANGELIDES**

Treasurer of the State of California

P.O. Box 942809

Sacramento, California 94209-0001

(800) 900-3873

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## **OFFICIAL STATEMENT**

**\$359,160,000**

### **STATE OF CALIFORNIA**

#### **VETERANS GENERAL OBLIGATION BONDS**

**\$155,350,000 Series CC (Non-AMT)**

**\$203,810,000 Series CD (AMT)**

## **INTRODUCTION**

This Introduction contains only a brief summary of the terms of the State of California Veterans General Obligation Bonds Series CC (the “Series CC Bonds”); Veterans General Obligation Bonds Series CD (the “Series CD Bonds” and, together with the Series CC Bonds, the “Offered Veterans G.O. Bonds”) and a brief description of the Official Statement; a full review should be made of the entire Official Statement, including the Appendices and information incorporated by reference. Summaries of provisions of the Constitution and laws of the State of California or any other documents referred to in this Official Statement do not purport to be complete and such summaries are qualified in their entirety by references to the complete provisions.

### **Description of the Offered Veterans G.O. Bonds**

The issuance of veterans general obligation bonds and commercial paper notes (“Veterans G.O. Bonds”) is authorized by Bond Acts (defined below) approved by the voters of the State of California (the “State”) and by resolutions of the Veterans Finance Committee of 1943. The Offered Veterans G.O. Bonds are authorized by specific Bond Acts, to finance, or to refinance obligations that were issued to provide funds for the financing of contracts (“Contracts of Purchase”) for the purchase of homes and farms for California military veterans under the Farm and Home Purchase Program (the “Program”) of the Department of Veterans Affairs of the State (the “Department”). The Offered Veterans G.O. Bonds are being issued for the purpose of (i) effecting a favorable reorganization of the debt structure of the State; (ii) funding Contracts of Purchase to be originated in the future; (iii) reimbursing the Department for existing Contracts of Purchase previously funded by the 1943 Fund; (iv) refunding certain outstanding Veterans G.O. Bonds; and (v) after replacing certain moneys that, for Federal tax purposes only, will be treated as refunding certain outstanding commercial paper, providing moneys to finance new Contracts of Purchase. See “THE OFFERED VETERANS G.O. BONDS – Purpose” and “– Identification and Authorization of the Offered Veterans G.O. Bonds.”

The Department anticipates that contemporaneously with the issuance of the Offered Veterans G.O. Bonds the Department will issue \$144,360,000 of the Department’s Home Purchase Revenue Bonds, 2006 Series A (the “2006 Revenue Bonds”). The Department also plans to convert to fixed interest rates \$92,000,000 of the Department’s Home Purchase Revenue Bonds, 2003 Series A (which will be redesignated as 2003 Subseries A-3 Bonds upon conversion). The Offered Veterans G.O. Bonds and the 2006 Revenue Bonds are separate and independent bond issues, although the Offered Veterans G.O. Bonds and the 2006 Revenue Bonds are treated as a single issue for certain Federal tax purposes. The sale and issuance of the Offered Veterans G.O. Bonds is not dependent upon the sale and issuance of the 2006 Revenue Bonds or the conversion of certain of the 2003 Series A Bonds. The Offered Veterans G.O. Bonds and the 2006 Revenue Bonds will each be offered and sold pursuant to separate official

statements, copies of which, when available, may be obtained from the Department or the State Treasurer (see – “Additional Information” below).

See EXHIBIT 2 TO APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds – Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds” for information about Veterans G.O. Bonds and Revenue Bonds expected to be refunded and “– Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” for information regarding the amount of money currently available and also expected to be made available to finance Contracts of Purchase upon the issuance of the Offered Veterans G.O. Bonds.

The Offered Veterans G.O. Bonds will be registered in the name of a nominee of The Depository Trust Company (“DTC”) which will act as securities depository for the Offered Veterans G.O. Bonds. Beneficial interests in the Offered Veterans G.O. Bonds may be purchased in book-entry form only, in denominations of \$5,000 or any integral multiple thereof. Principal and interest are payable as specified on the front cover page of this Official Statement. See APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.”

### **Security for and Sources of Payment for Veterans G.O. Bonds**

The Offered Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State are pledged (see “AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS – Security for and Payment of Veterans G.O. Bonds” herein). Principal of, premium, if any and interest on all State general obligations bonds, including Offered Veterans G.O. Bonds, are payable from moneys in the General Fund of the State Treasury (the “General Fund”), subject only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education. See APPENDIX A – “THE STATE OF CALIFORNIA – STATE FINANCES – The General Fund” and “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – General Obligation Bonds.” The Bond Acts authorizing the Offered Veterans G.O. Bonds provide that the State shall collect annually, in the same manner and at the same time as it collects other State revenues, a sum sufficient, in addition to the ordinary revenues of the State, to pay the principal of and interest on the Offered Veterans G.O. Bonds. State law requires funds equal to debt service on the Offered Veterans G.O. Bonds to be transferred to the General Fund from the Veterans Farm and Home Building Fund of 1943 (the “1943 Fund”) in accordance with procedures described in the Bond Acts. See “AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS – Security for and Payment of Veterans G.O. Bonds” and APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND.”

### **Redemption**

The Offered Veterans G.O. Bonds are subject to optional and special redemption prior to maturity. In addition, (i) the Series CC Bonds maturing December 1, 2023, December 1, 2030, December 1, 2033, December 1, 2037 and December 1, 2040 and (ii) the Series CD Bonds maturing December 1, 2024, December 1, 2026, December 1, 2029 and December 1, 2032 are subject to mandatory redemption at par prior to their stated maturities, in part, from sinking fund payments made by the State. See “THE OFFERED VETERANS G.O. BONDS – Redemption.”

## **Information Related to this Official Statement**

The information set forth herein has been obtained from official sources which are believed to be reliable, but it is not guaranteed as to accuracy or completeness. The information and expressions of opinion herein are subject to change without notice, and neither delivery of this Official Statement nor any sale made hereunder or any future use of this Official Statement shall, under any circumstances, create any implication that there has been no change in the affairs of the State or the Department since the date hereof.

All financial and other information presented or incorporated by reference in this Official Statement has been provided by, respectively, the State or the Department from its records, *except* for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information and is not intended to indicate future or continuing trends in the financial position or other affairs of, respectively, the State or the Department. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future. However, certain statements included or incorporated by reference in this Official Statement do constitute “forward-looking statements.” Such statements are generally identifiable by the terminology used such as “plan,” “expect,” “estimate,” “budget” or similar words. The achievement of certain results or other expectations contained in such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievement described to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Any statements made in this Official Statement involving matters of opinion, projections or estimates, whether expressly stated or not, are set forth as such and not as representations of fact.

A wide variety of other information, including financial information, concerning the State is available from State agencies, State agency publications and State agency websites. Any such information that is inconsistent with the information set forth in this Official Statement should be disregarded. No such information is a part of or incorporated into this Official Statement, except as expressly noted. See “FINANCIAL STATEMENTS” AND APPENDIX A – “THE STATE OF CALIFORNIA – FINANCIAL STATEMENTS”.

The information in APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM” has been furnished by The Depository Trust Company and no representation is made by the State or the Co-Financial Advisors as to the accuracy or completeness of such information.

No dealer, broker, salesperson or other person has been authorized by the State to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the State. This Official Statement is not to be construed as a contract with the purchasers of the Offered Veterans G.O. Bonds.

## **Tax Matters**

In the opinion of Hawkins Delafield & Wood LLP, Bond Counsel to the State, under existing statutes and court decisions and assuming continuing compliance by the State and the Department with certain tax covenants described therein, (i) interest on the Offered Veterans G.O. Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the “Federal Tax Code”), and such interest is exempt from personal income taxes of the State of California under present State law, (ii) interest on the Series CC Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Federal Tax Code; such interest, *however*, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations, and (iii) interest on the Series CD Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Federal Tax Code. See “TAX MATTERS” below, APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS” and APPENDIX G – “PROPOSED FORM OF LEGAL OPINION OF BOND COUNSEL TO THE STATE.”

## **Plan of Distribution**

The Offered Veterans G.O. Bonds were sold at competitive bid on November 9, 2006.

This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Offered Veterans G.O. Bonds, by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale.

## **Continuing Disclosure**

The State Treasurer (the “State Treasurer”) will agree on behalf of the State to provide annually certain financial information and operating data relating to the State by not later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the “Treasurer’s Annual Report”), commencing with the report for the 2005-2006 Fiscal Year, and to provide notices of the occurrence of certain other enumerated events if material. The Secretary of the Department will agree to provide annually certain financial information and operating data relating to the Program by not later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the “Department’s Annual Report”). The specific nature of the information to be contained in the Treasurer’s Annual Report and the Department’s Annual Report or the notices of material events and certain other terms of the continuing disclosure obligations are summarized in APPENDIX D – “SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES.”

The State and the Department have not failed to comply, in all material respects, with any “previous undertakings,” as that term is used in Rule 15c2-12 promulgated under the Securities Exchange Act of 1934, as amended.

In addition, the successful bidders have agreed to promptly file a copy of the final Official Statement, including any supplements prepared by the State, with each Nationally Recognized Municipal Securities Information Repository, and take any and all other actions necessary to comply with applicable Securities and Exchange Commission and Municipal Securities Rulemaking Board rules governing the offering, sale and delivery of the Offered Veterans G.O. Bonds to ultimate purchasers.



## **Additional Information**

Questions regarding this Official Statement and the issuance of these securities may be addressed to the office of the Honorable Philip Angelides, Treasurer of the State of California, P.O. Box 942809, Sacramento, California 94209-0001, telephone (800) 900-3873. Questions regarding the Program and the Official Statement relating to the 2006 Revenue Bonds should be addressed to the Bond Finance Division of the Department of Veterans Affairs, P.O. Box 942895, Sacramento, California 94295-0001, telephone (916) 653-2081.

## **AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS**

### **Authorization**

Each general obligation bond act authorizing the issuance of Veterans G.O. Bonds (each, a “Bond Act”) incorporates by reference the State General Obligation Bond Law (the “Law”), which is set forth in Chapter 4 (commencing with Section 16720) of Part 3 of Division 4 of Title 2 of the California Government Code. The Law provides for the authorization, sale, issuance, use of proceeds, repayment and refunding of State general obligation bonds.

Currently, \$485,585,000 of new issue Veterans G.O. Bonds (excluding the Offered Veterans G.O. Bonds) are authorized under Bond Acts but not issued. See APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE 1943 FUND – General.”

### **Security for and Payment of Veterans G.O. Bonds**

Veterans G.O. Bonds are general obligations of the State, payable in accordance with the Bond Acts out of the General Fund. The full faith and credit of the State are pledged for the punctual payment of the principal of and the interest on Veterans G.O. Bonds. All payments of principal, premium, if any, and interest on all State general obligation bonds, including Offered Veterans G.O. Bonds, have an equal claim to the General Fund, subject only to the prior application of moneys in the General Fund to the support of the public school systems and public institutions of higher education. See APPENDIX A – “THE STATE OF CALIFORNIA – STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – General Obligation Bonds.” The Bond Acts provide that the State shall collect annually in the same manner and at the same time as it collects other State revenue an amount sufficient, in addition to the ordinary revenue of the State, to pay principal of and interest on the Veterans G.O. Bonds. The Bond Acts also contain a continuing appropriation from the General Fund of the sum annually necessary to pay the principal of and the interest on the Veterans G.O. Bonds as they become due and payable.

The Department’s principal fund is the 1943 Fund described in APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE 1943 FUND.” The Military and Veterans Code of the State (the “Veterans Code”), of which the Bond Acts are a part, requires that, with respect to Veterans G.O. Bonds other than those issued under the Veterans Bond Act of 2000 (the “2000 Bond Act”), on the dates when funds are to be remitted to bondowners for the payment of debt service on such Veterans G.O. Bonds in each fiscal year, there shall be transferred to the General Fund to pay the debt service on such Veterans G.O. Bonds all of the money in the 1943 Fund (but not in excess of the amount of debt service then due and payable). The 2000 Bond Act

provides that on the dates when funds in the General Fund are remitted to bondowners for the payment of debt service on Veterans G.O. Bonds issued under the 2000 Bond Act, moneys shall be returned to the General Fund from the 1943 Fund in an amount equal to such debt service payment (to the extent sufficient moneys are available in the 1943 Fund). If the money so transferred on the remittance dates is less than the debt service then due and payable or the reimbursement, as applicable, the balance remaining unpaid is required by the Veterans Code to be transferred to the General Fund out of the 1943 Fund as soon as it shall become available, together with interest thereon from the remittance date until paid, at the same rate of interest as borne by the applicable Veterans G.O. Bonds, compounded semiannually. The 1943 Fund has always maintained moneys in an amount sufficient to make the required debt service payment to the General Fund.

The Veterans Code does not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds. As of June 30, 2006, there were outstanding \$1,335,640,000 aggregate principal amount of Veterans G.O. Bonds and commercial paper notes, not including the Offered Veterans G.O. Bonds. Outstanding Home Purchase Revenue Bonds in the aggregate principal amount of \$543,360,000 (as of June 30, 2006, and not including the 2006 Revenue Bonds) previously issued by the Department (collectively with any additional Home Purchase Revenue Bonds issued by the Department in the future, the "Revenue Bonds") are and will be special obligations of the Department payable solely from, and secured by a pledge of, an undivided interest in the assets of the 1943 Fund (other than proceeds of Veterans G.O. Bonds or any amounts in any rebate account) and any reserve accounts established for the benefit of Revenue Bonds. The Veterans Code provides that this undivided interest in the 1943 Fund is secondary and subordinate to any interest or right in the assets of the 1943 Fund of the people of the State and of the holders of the Veterans G.O. Bonds (that is, the right to payment or reimbursements of debt service on Veterans G.O. Bonds described in the preceding paragraph). If debt service payments to the General Fund are current and all transfers equal to debt service payments with interest as described in the preceding paragraph have been made, no holder or beneficial owner of Veterans G.O. Bonds has any right to restrict disbursements by the Department from the 1943 Fund for any lawful purpose, including payment of debt service on or redemptions and purchases of Revenue Bonds.

For additional information, see APPENDIX B – "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE 1943 FUND" and EXHIBIT 1 to APPENDIX B – "FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 2006 AND 2005 AND INDEPENDENT AUDITORS' REPORT."

## **Remedies**

It is an event of default of the State under the Resolutions authorizing the Offered Veterans G.O. Bonds pursuant to the respective Bond Acts to fail to pay or to fail to cause to be paid, when due, or to declare a moratorium on the payment of, or to repudiate any Offered Veterans G.O. Bond.

In the case one or more events of default occurs, then and in every such case the registered Bondholder is entitled to proceed to protect and enforce such registered Bondholder's rights by such appropriate judicial proceeding as such registered Bondholder deems most effectual to protect and enforce any such right, whether by mandamus or other suit or proceeding

at law or in equity, for the specific performance of any covenant or agreement contained in the Resolutions authorizing the Offered Veterans G.O. Bonds, as more specially set forth in each Resolution authorizing the Offered Veterans G.O. Bonds pursuant to the respective Bond Acts. Beneficial owners of the Bonds (the “Beneficial Owners”) cannot protect and enforce such rights except through the registered Bondholder. See “THE OFFERED VETERANS G.O. BONDS – General” and APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.”

## **THE OFFERED VETERANS G.O. BONDS**

### **General**

The Offered Veterans G.O. Bonds will be registered in the name of the nominee of DTC, which will act as securities depository for the Offered Veterans G.O. Bonds. Beneficial interests in the Offered Veterans G.O. Bonds may be purchased in book-entry form only, in denominations of \$5,000 or any integral multiple thereof. See APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.”

Neither the State Treasurer nor the initial purchaser can or does give any assurances that DTC will distribute to Participants, or that Participants or others will distribute to the Beneficial Owners, payment of principal of and interest on the Offered Veterans G.O. Bonds paid or any redemption or other notices or that they will do so on a timely basis or will serve and act in the manner described in this Official Statement. Neither the State Treasurer nor the initial purchaser is responsible or liable for the failure of DTC or any Direct Participant or Indirect Participant to make any payments or give any notice to a Beneficial Owner with respect to the Offered Veterans G.O. Bonds or any error or delay relating thereto.

The Offered Veterans G.O. Bonds will be dated the Dated Date (as shown on the cover page hereof) and will mature on the respective dates and in the respective amounts set forth on the inside cover page hereof. Interest on the Offered Veterans G.O. Bonds will accrue from the Dated Date at the respective rates shown on the inside cover page of this Official Statement. Interest on the Offered Veterans G.O. Bonds is payable on June 1 and December 1 in each year (each, an “Interest Payment Date”) commencing June 1, 2007 and shall be calculated on the basis of a 360-day year comprised of twelve 30-day months.

Principal and interest are payable directly to DTC by the State Treasurer. Upon receipt of payments of principal and interest, it is the responsibility of DTC to in turn remit such principal and interest to the participants in DTC for disbursement to the beneficial owners of the Offered Veterans G.O. Bonds. The record date for the payment of interest on the Offered Veterans G.O. Bonds is the close of business on the 15th day of the month immediately preceding an Interest Payment Date, whether or not the record date falls on a business day.

### **Purpose**

Under the Program, the Department acquires residential property to be sold to eligible veterans under Contracts of Purchase between the Department and such veterans. Such acquisition is financed principally with the proceeds of Veterans G.O. Bonds and the Department’s Revenue Bonds. The Offered Veterans G.O. Bonds are being issued for the purpose of (i) effecting a favorable reorganization of the debt structure of the State; (ii) funding Contracts of Purchase to be originated in the future; (iii) reimbursing the Department for existing Contracts of Purchase previously funded by the 1943 Fund; and (iv) refunding certain outstanding Veterans G.O. Bonds; and (v) after replacing certain moneys that, for Federal tax

purposes only, will be treated as refunding certain outstanding commercial paper, providing moneys to finance new Contracts of Purchase. See EXHIBIT 2 TO APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds – Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds” for information about Veterans G.O. Bonds expected to be refunded and “– Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” for information regarding the amount of money expected to be made available to finance Contracts of Purchase upon the issuance of the Offered Veterans G.O. Bonds.

See EXHIBIT 2 to APPENDIX B – “DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – Certain Department Financial Information and Operating Data – Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments.”

### **Identification and Authorization of the Offered Veterans G.O. Bonds**

The Series CC Bonds and Series CD Bonds are issued under separate Bond Acts, authorized by the voters, as described below. See APPENDIX A – “THE STATE OF CALIFORNIA – STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – General Obligation Bonds.”

#### *Authorization*

\$200,000 principal amount of Veterans General Obligation Bonds, Series CC1, authorized under the Veterans Bond Act of 1988.

\$34,875,000 principal amount of Veterans General Obligation Bonds, Series CC2, authorized under the Veterans Bond Act of 1996.

\$120,275,000 principal amount of Veterans General Obligation Bonds, Series CC3, authorized under the Veterans Bond Act of 2000.

\$19,280,000 principal amount of Veterans General Obligation Bonds, Series CD1, authorized under the Veterans Bond Act of 1986.

\$34,525,000 principal amount of Veterans General Obligation Bonds, Series CD2, authorized under the Veterans Bond Act of 1988.

\$64,595,000 principal amount of Veterans General Obligation Bonds, Series CD3, authorized under the Veterans Bond Act of 1990.

\$85,410,000 principal amount of Veterans General Obligation Bonds, Series CD4, authorized under the Veterans Bond Act of 1996.

### **Redemption**

#### *Sinking Fund Redemption*

The Series CC Bonds maturing on December 1, 2023, December 1, 2030, December 1, 2033, December 1, 2037 and December 1, 2040, respectively (the “Series CC Term Bonds”), are subject to redemption prior to their respective stated maturity dates, in part, by lot, from sinking fund payments, at a redemption price of 100 percent of the principal amount thereof, plus

accrued interest to the date fixed for redemption, without premium, on the respective dates and in the respective amounts shown below.

#### SINKING FUND REDEMPTION SCHEDULE

<u>December 1</u>	<u>Series CC Term Bonds Maturing December 1, 2023</u>	<u>Series CC Term Bonds Maturing December 1, 2030</u>	<u>Series CC Term Bonds Maturing December 1, 2033</u>	<u>Series CC Term Bonds Maturing December 1, 2037</u>	<u>Series CC Term Bonds Maturing December 1, 2040</u>
2021	\$ 1,050,000				
2022	100,000				
2023	100,000 <sup>†</sup>				
2024		\$ 200,000			
2025		200,000			
2026		100,000			
2027		950,000			
2028		950,000			
2029		5,685,000			
2030		6,470,000 <sup>†</sup>			
2031			\$ 6,760,000		
2032			7,070,000		
2033			12,705,000 <sup>†</sup>		
2034				\$ 13,310,000	
2035				13,945,000	
2036				14,610,000	
2037				15,300,000 <sup>†</sup>	
2038					\$ 16,025,000
2039					16,790,000
2040					17,590,000 <sup>†</sup>
Total	\$1,250,000	\$14,555,000	\$26,535,000	\$57,165,000	\$50,405,000

<sup>†</sup> Stated Maturity.

The Series CD Bonds maturing on December 1, 2024, December 1, 2026, December 1, 2029 and December 1, 2032, respectively (the “Series CD Term Bonds” and together with the Series CC Term Bonds, the “Term Bonds”), are subject to redemption prior to their respective stated maturity dates, in part, by lot, from sinking fund payments, at a redemption price of 100 percent of the principal amount thereof, plus accrued interest to the date fixed for redemption, without premium, on the respective dates and in the respective amounts shown below.

### SINKING FUND REDEMPTION SCHEDULE

<u>December 1</u>	<u>Series CD Term Bonds Maturing December 1, 2024</u>	<u>Series CD Term Bonds Maturing December 1, 2026</u>	<u>Series CD Term Bonds Maturing December 1, 2029</u>	<u>Series CD Term Bonds Maturing December 1, 2032</u>
2023	\$ 11,890,000			
2024	11,900,000 <sup>†</sup>			
2025		\$ 12,605,000		
2026		16,595,000 <sup>†</sup>		
2027			\$ 16,885,000	
2028			17,365,000	
2029			17,880,000 <sup>†</sup>	
2030				\$ 18,425,000
2031				18,995,000
2032				19,620,000 <sup>†</sup>
Total	\$23,790,000	\$29,200,000	\$52,130,000	\$57,040,000

<sup>†</sup> Stated Maturity.

If less than all of the Term Bonds of the same series and maturity date are purchased or called for redemption (other than in satisfaction of sinking fund payments), the State Treasurer will credit the principal amount of such Term Bonds that are so purchased or redeemed against applicable remaining sinking fund payments relating to such Term Bonds (including the principal amounts due on the respective maturity dates, as shown above), as requested by the Department.

#### *Optional Redemption*

The Offered Veterans G.O. Bonds are subject to optional redemption prior to their respective stated maturity dates, at the option of the State upon request of the Department, in whole or in part (of any maturity of any Series, and by lot within each maturity), on any date on or after December 1, 2015 from any moneys made available for such purpose, at a redemption price equal to 100% of the Offered Veterans G.O. Bonds to be redeemed, without premium plus accrued interest thereon to the redemption date.

#### *Special Redemption from Unexpended Proceeds*

The Offered Veterans G.O. Bonds are subject to redemption on any date prior to their respective stated maturity dates in an amount up to \$50,275,000, at the option of the Department from moneys deposited in the GO Bond Series Proceeds Subaccount with respect to the Offered Veterans G.O. Bonds that have not been applied to finance Contracts of Purchase. Any such redemption may be in part (and of any maturity of any Series at the option of the State upon a request of the Department and by lot within such maturity), at the principal amount thereof plus accrued interest to the date fixed for redemption, without premium. See EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” for a discussion of the amount of moneys expected to be deposited in the GO Bond Series Proceeds Subaccount upon the issuance of the Offered Veterans G.O. Bonds.

Factors which may affect the demand for Contracts of Purchase and consequently the Department's ability to use all of the proceeds of the Offered Veterans G.O. Bonds and Excess Revenues (as defined below) for the financing of Contracts of Purchase include not only general economic conditions, but also (among other factors) the relationship between alternative mortgage loan interest rates (including rates on mortgage loans insured or guaranteed by agencies of the federal government, rates on conventional mortgage loans and the rates on other Contracts of Purchase available from the Department), the interest rates being charged on Contracts of Purchase by the Department, the general level of home purchase and construction activity in the State and the demographics of the eligible veterans population. These factors could cause a lack of demand for Contracts of Purchase financed by the Offered Veterans G.O. Bonds and could necessitate the exercise by the Department of its right to apply the unused proceeds and Excess Revenues to redeem the Offered Veterans G.O. Bonds. See EXHIBIT 2 to APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – New Contracts of Purchase During the Fiscal Year" for information regarding the recent rate of originations of Contracts of Purchase, and " – Selected Principal Flows" with respect to Contracts of Purchase Funded by both Veterans G.O. Bonds and Revenue Bonds" for the interest rates on new Contracts of Purchase originated since January 1, 1999.

Moneys are currently available through the prior issuance of Veterans G.O. Bonds and Revenue Bonds to finance Contracts of Purchase, and additional moneys may become available to finance Contracts of Purchase through the concurrent and future issuances of Revenue Bonds and Veterans G.O. Bonds. Since the Department has full discretion, subject to eligibility requirements and the requirements of the Federal Tax Code, in applying the proceeds of all of these bonds to finance the Program, the proceeds of prior and future Veterans G.O. Bonds and Revenue Bonds may be used to finance Contracts of Purchase before proceeds of the Offered Veterans G.O. Bonds. See APPENDIX B – "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE PROGRAM – Qualifying Veteran Status" for information regarding eligibility requirements for different moneys made available by the Department and EXHIBIT 2 to APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments" for information regarding the amount of money currently available and expected to become available to finance Contracts of Purchase upon the issuance of the Offered Veterans G.O. Bonds.

#### *Special Redemption from Excess Revenues*

The Offered Veterans G.O. Bonds are subject to special redemption on any date prior to their respective stated maturity dates, at the option of the State upon request of the Department, from Excess Revenues derived from any Veterans G.O. Bonds or any Revenue Bonds. Any such redemption may be in whole or in part (and of any maturity of any Series at the option of the State upon request of the Department and by lot within such maturity), at the principal amount thereof plus accrued interest to the date fixed for redemption, without premium.

“Excess Revenues” means, as of any date of calculation, Revenues in excess of Accrued Debt Service. Excess Revenues can include prepayments and repayments on Contracts of Purchase funded by Revenue Bonds and Veterans G.O. Bonds, investment earnings, certain insurance receipts and also includes Revenues which had been set aside to be recycled into new Contracts of Purchase. All payments on Contracts of Purchase are deposited in the 1943 Fund and applied to pay or reimburse the State’s General Fund for debt service on the Veterans G.O. Bonds, to pay debt service on Revenue Bonds, to pay for mandatory redemptions of Veterans G.O. Bonds and Revenue Bonds, to pay Program and Department expenses, and to pay certain insurance claims. The Department, subject to applicable bond authorizing resolutions, may apply Excess Revenues to redeem any Veterans G.O. Bonds or Revenue Bonds eligible for redemption. The Department’s decision to apply Excess Revenues to redeem bonds, to finance new Contracts of Purchase, or for any other permitted purpose depends on many factors, including but not limited to applicable bond authorizing resolution requirements, demand for Contracts of Purchase, debt service cost savings, investment earnings, and Federal Tax Code requirements. A portion of the proceeds of the Offered Veterans G.O. Bonds will be used to reimburse the Department for its prior funding of existing Contracts of Purchase. Such amounts will be deposited to a Recycling Subaccount under the Revenue Bond Resolution. The Department presently plans to apply such funds to fund additional Contracts of Purchase. To the extent that such monies are not applied to the funding of additional Contracts of Purchase, as Revenues they will be applied in accordance with the Revenue Bond Resolution, including application as Excess Revenues. See EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL AND OPERATING DATA – AMOUNTS EXPECTED TO BE AVAILABLE TO FUND CONTRACTS OF PURCHASE AND RELATED INVESTMENTS.” See APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE 1943 FUND – Excess Revenues.”

Certain of the currently outstanding Veterans G.O. Bonds are not subject to redemption prior to maturity. See EXHIBIT 2 to APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA.”

The Department’s actual past prepayment experience for existing Contracts of Purchase is set forth in EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience.”

For certain qualified mortgage bonds issued or to be issued after 1988, the Federal Tax Code prohibits repayments (including prepayments) of principal of Contracts of Purchase financed with the proceeds of an issue of such bonds to be used to make additional Contracts of Purchase after 10 years from the date of issuance of such bonds (or the date of issuance of original bonds in the case of refundings), after which date such amounts must be used to redeem such bonds of the issue, except for a \$250,000 *de minimis* amount. See “TAX MATTERS – Federal Tax Matters.”



The Federal Tax Code requires a payment to the United States from certain veterans whose Contracts of Purchase are originated after December 31, 1990 with the proceeds of qualified mortgage bonds. Since such requirement remains in effect with respect to any Contracts of Purchase originated after December 31, 1990 with proceeds of the applicable Revenue Bonds, for a period ending nine years after the execution of such Contracts of Purchase, the Department is unable to predict what effect, if any, such requirement will have on the origination or prepayment of Contracts of Purchase to which such provision applies.

### **Notice of Redemption**

When redemption is required while the Offered Veterans G.O. Bonds are in book-entry form, the State Treasurer is to give notice of redemption by mailing copies of such notice only to DTC (not to the beneficial owners of the Offered Veterans G.O. Bonds) not less than thirty or more than sixty days prior to the date fixed for redemption. DTC, in turn, is to send the notice of redemption to its participants for distribution to the beneficial owners of the Offered Veterans G.O. Bonds. See APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.” The notice from the State Treasurer will state, among other things, that the Offered Veterans G.O. Bonds or a designated portion thereof (in the case of partial redemption of an Offered Veterans G.O. Bond) are to be redeemed, the dated date of the Offered Veterans G.O. Bonds, the redemption date, the Series and maturities of the Offered Veterans G.O. Bonds to be redeemed and the redemption price. The notice will also state that after the date fixed for redemption, no further interest will accrue on the principal of any Offered Veterans G.O. Bonds called for redemption. Notice of redemption will also be provided by mail to certain financial information services and securities depositories.

## **TAX MATTERS**

### **Federal Tax Matters**

The Offered Veterans G.O. Bonds are considered a single issue for Federal income tax purposes with the 2006 Revenue Bonds. The requirements of applicable Federal tax law must be satisfied with respect to each series of the Offered Veterans G.O. Bonds and the 2006 Revenue Bonds in order that interest on the Offered Veterans G.O. Bonds not be included in gross income for Federal income tax purposes retroactive to the date of issuance thereof. Proceeds of the Offered Veterans G.O. Bonds and the 2006 Revenue Bonds must be used to retire outstanding bonds within ninety days of their respective dates of issuance. Failure to so use all of such proceeds and to comply with other requirements of the Federal Tax Code with respect to either the Offered Veterans G.O. Bonds or the 2006 Revenue Bonds could cause interest on the Offered Veterans G.O. Bonds to be included in gross income for Federal income tax purposes retroactive to their date of issuance.

#### *Requirements Imposed on the Offered Veterans G.O. Bonds and the 2006 Revenue Bonds by the Federal Tax Code*

The Federal Tax Code contains the following loan eligibility requirements which are applicable (with certain exceptions), in whole or in part, to Contracts of Purchase (or portions of Contracts of Purchase) entered into with respect to properties acquired with amounts allocable to qualified veterans' mortgage bonds and/or to qualified mortgage bonds. The Offered Veterans G.O. Bonds are qualified veterans' mortgage bonds and not qualified mortgage bonds, and the 2006 Revenue Bonds are Pre-Ullman bonds (as such terms are defined in APPENDIX E). The

2006 Revenue Bonds are treated for Federal income tax purposes as refunding certain existing Pre-Ullman bonds issued to finance the Program. The moneys which will be made available from the issuance of the Offered Veterans G.O. Bonds to finance Contracts of Purchase will be QVMB Proceeds, while the moneys which will be made available from the issuance of the 2006 Revenue Bonds to finance Contracts of Purchase will be Unrestricted Moneys (as such terms are defined in APPENDIX B). The loan eligibility requirements described in APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS” do not apply to Unrestricted Moneys. These requirements also do not apply to the Contracts of Purchase to be allocated to the 2006 Revenue Bonds for Federal income tax purposes following payment of the bonds being refunded by the 2006 Revenue Bonds, including any new Contracts of Purchase so allocated. The Federal Tax Code establishes other requirements described below which will apply to the 2006 Revenue Bonds.

The first general requirement of the Federal Tax Code which is applicable to qualified veterans’ mortgage bonds is that the aggregate amount that may be issued must not exceed the volume limit based upon statutory formula. The Offered Veterans G.O. Bonds are in compliance with such requirement.

The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified mortgage bonds and qualified veterans’ mortgage bonds (such as the Offered Veterans G.O. Bonds) may not exceed the yield on the issue by more than 1.125% (1.50% for Pre-Ullman bonds such as the 2006 Revenue Bonds) (see “Yield Limitations and Rebate” in APPENDIX E) and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans. The Department has covenanted to comply with these requirements and has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE PROGRAM – Contracts of Purchase” for discussions of provisions of the Veterans Code which affect the Department’s ability to establish and to change interest rates on Contracts of Purchase.

#### *Opinion of Bond Counsel to the State*

In the opinion of Bond Counsel to the State (expected to be delivered in substantially the form set forth with respect to the Offered Veterans G.O. Bonds in APPENDIX G), under existing statutes and court decisions and assuming continuing compliance with certain tax covenants described herein, (i) interest on the Offered Veterans G.O. Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Code, (ii) interest on the Series CC Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Federal Tax Code; such interest, *however*, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations, and (iii) interest on the Series CD Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Federal Tax Code.

In rendering the foregoing opinions, Bond Counsel to the State has assumed and continues to assume compliance by the State and the Department with and enforcement by the State and the Department of the documents authorizing the issuance of the Offered Veterans G.O. Bonds and the 2006 Revenue Bonds and the applicable Program Documents (as such term is defined in APPENDIX E). Bond Counsel to the State has expressed and expresses no opinion as to the exclusion from gross income of interest on any Offered Veterans G.O. Bonds subsequent to any date on which action is taken pursuant to the documents authorizing the issuance of the Offered Veterans G.O. Bonds, for which action such documents require a legal opinion to the effect that taking such action will not adversely affect such exclusion, unless such firm delivers an opinion as of such date to such effect.

In rendering its opinions, Bond Counsel to the State expresses no opinion regarding any other Federal or, except as stated below under “State Tax Matters,” state tax consequences with respect to the Offered Veterans G.O. Bonds. Bond Counsel to the State renders its opinions under existing statutes and court decisions as of the issue date, and assumes no obligation to update its opinions after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation, or otherwise. In rendering its opinions, Bond Counsel to the State expresses no opinion on the effect of any action taken after the date of the opinion or not taken in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Offered Veterans G.O. Bonds, or under state and local tax law.

#### *Certain Collateral Federal Tax Consequences*

The following is a brief discussion of certain Federal income tax matters with respect to the Offered Veterans G.O. Bonds under existing statutes. It does not purport to deal with all aspects of Federal taxation that may be relevant to a particular owner of an Offered Veterans G.O. Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the Federal tax consequences of owning and disposing of the Offered Veterans G.O. Bonds.

As noted above, interest on the Series CD Bonds is, and interest on the Series CC Bonds is not, a preference item in determining the tax liability of individuals, corporations, and other taxpayers subject to the alternative minimum tax imposed by Section 55 of the Federal Tax Code. Interest on the Offered Veterans G.O. Bonds must also be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Federal Tax Code.

Prospective Owners of Offered Veterans G.O. Bonds should be aware that the ownership of such obligations may result in collateral Federal income tax consequences to various categories of persons, such as corporations (including S corporations and certain foreign corporations), financial institutions, property and casualty insurance companies, individual recipients of Social Security or Railroad Retirement benefits, and individuals otherwise eligible for the earned income tax credit and to taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is not included in gross income for Federal income tax purposes.

Legislation affecting municipal bonds is frequently considered by the United States Congress. There can be no assurance that legislation enacted or proposed after the date of issuance of the Offered Veterans G.O. Bonds will not have an adverse effect on the tax-exempt status or market price of the Offered Veterans G.O. Bonds.

### **State Tax Matters**

In the opinion of Bond Counsel to the State to be rendered with respect to the Offered Veterans G.O. Bonds on the date of delivery thereof, interest on the Offered Veterans G.O. Bonds is exempt from personal income taxes of the State of California under State law in effect on the date of such opinion. A complete copy of the proposed form of opinion to be rendered with respect to the Offered Veterans G.O. Bonds is contained in APPENDIX G.

### **LEGAL OPINIONS**

The opinion of the Honorable Bill Lockyer, Attorney General of the State of California (the "Attorney General"), approving the validity of the Offered Veterans G.O. Bonds, will accompany the Offered Veterans G.O. Bonds deposited with DTC. The opinion of Bond Counsel to the State approving the validity of the Offered Veterans G.O. Bonds and addressing certain tax matters will also accompany the Offered Veterans G.O. Bonds deposited with DTC. The proposed forms of the legal opinions of the Attorney General and Bond Counsel to the State are set forth in APPENDIX F and APPENDIX G, respectively.

Certain legal matters will be passed upon by Quateman LLP, Disclosure Counsel to the State, and by Orrick, Herrington & Sutcliffe LLP, Disclosure Counsel to the State regarding APPENDIX A.

The Attorney General, Bond Counsel to the State, Disclosure Counsel to the State and Disclosure Counsel to the State regarding APPENDIX A undertake no responsibility for the accuracy, completeness or fairness of this Official Statement.

### **LITIGATION**

The Attorney General has advised that, to his knowledge, no litigation is now pending (with service of process on the State or the Department having been accomplished) or threatened seeking to restrain or enjoin the sale, issuance, execution or delivery of the Offered Veterans G.O. Bonds or challenging the validity of the Offered Veterans G.O. Bonds or any proceedings of the State or of the Department taken with respect to the foregoing.

At any given time, including the present, there are numerous civil actions pending against the State (including, but not limited to, those discussed in APPENDIX A), that could, if determined adversely to the State, affect the State's expenditures and, in some cases, its revenues and cash flow. While there can be no assurances as to the ultimate outcome and fiscal impact of such litigation, the State believes that it is unlikely that the outcome of any such litigation could materially adversely affect the State's ability to pay principal of, and interest on the Offered Veterans G.O. Bonds when due. See APPENDIX A – "THE STATE OF CALIFORNIA – LITIGATION."

There may, from time to time, be litigation affecting the Department that does not directly relate to the Veterans G.O. Bonds, which may nonetheless relate to the 1943 Fund.

## **FINANCIAL STATEMENTS**

Audited Basic Financial Statements of the State of California (the “Financial Statements”) for the Fiscal Year ended June 30, 2005 have been filed with all of the Nationally Recognized Municipal Securities Information Repositories, as part of the Official Statement for certain State of California Bonds sold in 2006 and are incorporated by reference into this Official Statement. The Financial Statements are also available through electronic means. SEE APPENDIX A – “THE STATE OF CALIFORNIA – FINANCIAL STATEMENTS.” Certain unaudited financial information for the twelve months ended June 30, 2006 and the three months ended October 31, 2006 is included as exhibits to APPENDIX A. See “APPENDIX A – THE STATE OF CALIFORNIA – Financial Statements.”

## **INDEPENDENT AUDITORS**

Attached as EXHIBIT 1 TO APPENDIX B are the Financial Statements for the Veterans Farm and Home Building Fund of 1943 for the years ended June 30, 2006 and 2005. These statements have been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as indicated in their report appearing in APPENDIX B, which report expresses an unqualified opinion on the financial statements and includes an explanatory paragraph referring to management’s discussion and analysis.

## **RATINGS**

The Offered Veterans G.O. Bonds have received ratings of “A1” by Moody’s Investor Service (“Moody’s”), “AA-” by Standard and Poor’s, a Division of The McGraw-Hill Companies, Inc. (“S&P”), and “A+” by Fitch Ratings (“Fitch”). An explanation of the significance and status of such credit ratings may be obtained from the rating agencies furnishing the same. There is no assurance that such ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by any such rating agencies if, in their respective judgments, circumstances so warrant. Any revision or withdrawal of a credit rating could have an effect on the market prices and marketability of the Offered Veterans G.O. Bonds. The State cannot predict the timing or impact of future actions by the rating agencies. See APPENDIX A – “THE STATE OF CALIFORNIA – Introduction to Appendix A – California’s Credit and Rating History.”

## **FINANCIAL ADVISORS**

Gardner, Underwood & Bacon LLC and Public Resources Advisory Group have acted as co-financial advisors (collectively, the “Co-Financial Advisors”) to the State in connection with the issuance of the Offered Veterans G.O. Bonds. The Co-Financial Advisors have assisted the State in matters related to the planning, structuring, execution and delivery of the Offered Veterans G.O. Bonds. The Co-Financial Advisors have not been engaged, nor have they undertaken, to make an independent verification or assume responsibility for the accuracy, completeness, or fairness of the information contained in this Official Statement.

## **ADDITIONAL INFORMATION**

The Department will execute a certificate upon delivery of the Offered Veterans G.O. Bonds to the effect that, to the best of the Department’s knowledge and belief, as of the delivery date, the information and statements, including financial statements, contained in Appendix B in this Official Statement relating to the Offered Veterans G.O. Bonds are true and correct in all material respects and does not contain any untrue statement of a material fact or omit to state any

material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading. The State Treasurer will execute a certificate upon delivery of the Offered Veterans G.O. Bonds to the effect that, to the best of the State Treasurer's knowledge and belief, as of the delivery date, the information and statements, including financial statements, of or pertaining to the State contained in this Official Statement relating to the Offered Veterans G.O. Bonds (except for information in APPENDIX B, APPENDIX C and APPENDIX E, as to which the State Treasurer makes no representation) are true and correct in all material respects and does not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading.

STATE OF CALIFORNIA  
**PHILIP ANGELIDES**  
Treasurer of the State of California

APPENDIX A

THE STATE OF CALIFORNIA



*Honorable Philip Angelides*

*Treasurer of the State of California*

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## INTRODUCTION TO APPENDIX A

**Importance of APPENDIX A.** APPENDIX A is the part of the Official Statement that provides investors with information concerning the State of California. Investors are advised to read the entire Official Statement, including APPENDIX A, to obtain information essential to making an informed investment decision. Certain abbreviations and defined terms are shown at the end of this Introduction.

**Payment Priority of General Obligation Bonds.** The Bonds are general obligations of the state to which the full faith and credit of the State are pledged. Principal of, premium, if any, and interest on all State general obligation bonds, including the Bonds, are payable from any moneys in the General Fund of the State, subject only to the prior application of such moneys to the support of the public school system and public institutions of higher education.

**California's Credit and Rating History.** California has always paid the principal of and interest on its general obligation bonds, general obligation commercial paper notes, lease-purchase obligations and short-term obligations, including revenue anticipation notes and revenue anticipation warrants, when due.

After reaching their lowest point in 2003, the ratings of the state's general obligation bonds have been raised by all three rating agencies starting in 2004. Standard & Poor's has raised the state's general obligation credit rating from "BBB" to "A+." Moody's has raised the rating from "Baa1" to "A1." Fitch has raised the rating from "BBB" to "A+." The most recent actions by Moody's and S&P both took place in May, 2006 and the latest action by Fitch took place in June, 2006.

Any revisions or withdrawal of a credit rating could have an effect on the market price and liquidity of the Bonds. The state cannot predict the timing or impact of future actions by the rating agencies. See also "RATINGS" in the forepart of this Official Statement.

**Overview of APPENDIX A.** Following the Introduction, APPENDIX A begins with a brief summary of recent developments and a description of the types of debt instruments that the state has issued and is authorized to issue in the future. See "RECENT DEVELOPMENTS REGARDING STATE ECONOMY AND FINANCES" and "STATE INDEBTEDNESS AND OTHER OBLIGATIONS." A discussion of the state's current and projected cash flow is contained under "STATE INDEBTEDNESS AND OTHER OBLIGATIONS—Cash Flow Borrowings."

APPENDIX A continues with a discussion of the sources and uses of state funds. See "STATE FINANCES." The budget process and constraints on this process, as well as the budget proposed by the Governor and the economic assumptions underlying the revenue projections contained in the proposed budget, are discussed under "THE BUDGET PROCESS" and "CURRENT STATE BUDGET."

APPENDIX A incorporates by reference the Audited Basic Financial Statements of the state for the Year Ended June 30, 2005, together with certain information required by governmental accounting and financial reporting standards to be included in the Financial Statements, including a "Management's Discussion and Analysis" that describes and analyzes the financial position of the state and provides an overview of the state's activities for the fiscal year ended June 30, 2005. In addition, APPENDIX A contains the State Controller's unaudited reports of cash receipts and disbursements for the periods after June 30, 2005. See "FINANCIAL STATEMENTS."

Governance, management and employee information is set forth under "OVERVIEW OF STATE GOVERNMENT." Demographic and economic statistical information is included under "ECONOMY

AND POPULATION.” APPENDIX A concludes with a description of material litigation involving the state (see “LITIGATION”) and debt tables (see “STATE DEBT TABLES”).

**Certain Defined Terms.** The following terms and abbreviations are used in this APPENDIX A:

“2004 Budget Act” means the Budget Act for the 2004-05 Fiscal Year, adopted on July 31, 2004.

“2005-06 Governor’s Budget” means the Governor’s Proposed Budget for the 2005-06 Fiscal Year, released on January 10, 2005.

“2005-06 May Revision” means the May Revision of the 2005-06 Governor’s Budget, released on May 13, 2005.

“2005 Budget Act” means the Budget Act for the 2005-06 Fiscal Year, adopted on July 11, 2005.

“2006-07 Governor’s Budget” means the Governor’s Proposed Budget for the 2006-07 Fiscal Year, released on January 10, 2006.

“2006-07 May Revision” means the May Revision of the 2006-07 Governor’s Budget, released on May 12, 2006.

“2006 Budget Act” means the Budget Act for the 2006-07 Fiscal Year, adopted on June 30, 2006.

Reference to the “state” as a noun or adjective means the State of California, following the practice of the Department of Finance.

## **RECENT DEVELOPMENTS REGARDING STATE ECONOMY AND FINANCES**

The results of the November 7, 2006 election for seven statewide constitutional offices is set out below under “OVERVIEW OF STATE GOVERNMENT – Organization of State Government.” At the election, voters approved all five statewide bond measures on the ballot, totaling \$42.7 billion in new authorizations. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facility Financing” below. Voters also approved (in Proposition 1A) a limitation on the ability of the State to use sales taxes on motor vehicle fuels for purposes other than transportation projects. Finally, voters rejected four initiative measures which would have raised various taxes or imposed new taxes for a variety of specific programs.

## **STATE INDEBTEDNESS AND OTHER OBLIGATIONS**

### **General**

The State Treasurer is responsible for the sale of debt obligations of the state and its various authorities and agencies. The state has always paid the principal of and interest on its general obligation bonds, general obligation commercial paper notes, lease-purchase obligations and short-term obligations, including revenue anticipation notes and revenue anticipation warrants, when due.

### **Capital Facilities Financing**

#### *General Obligation Bonds*

The State Constitution prohibits the creation of general obligation indebtedness of the state unless a bond measure is approved by a majority of the electorate voting at a general election or a direct primary.

General obligation bond acts provide that debt service on general obligation bonds shall be appropriated annually from the General Fund and all debt service on general obligation bonds is paid from the General Fund. Under the State Constitution, debt service on general obligation bonds is the second charge to the General Fund after the application of moneys in the General Fund to the support of the public school system and public institutions of higher education. See “STATE FINANCES—State Expenditures.” Certain general obligation bond programs receive revenues from sources other than the sale of bonds or the investment of bond proceeds.

As of October 1, 2006, the state had outstanding \$48,882,257,000 aggregate principal amount of long-term general obligation bonds, of which \$37,215,497,000 were payable primarily from the state’s General Fund, and \$11,666,760,000 were payable from other revenue sources. See “—Economic Recovery Bonds” below. As of October 1, 2006, there were unused voter authorizations for the future issuance of \$30,237,291,000 of long-term general obligation bonds, not including bonds approved by the voters on November 7 (see below). This latter figure consists of \$18,108,127,000 of general obligation bonds which are authorized by state finance committees to be issued initially as commercial paper notes, described below, and \$12,129,164,000 of other authorized but unissued general obligation bonds. Of this unissued amount, \$4,399,185,000 is for bonds payable from other revenue sources (of which \$115,570,000 is authorized for commercial paper notes). See the table “Authorized and Outstanding General Obligation Bonds” under “STATE DEBT TABLES.”

General obligation bond law permits the state to issue as variable rate indebtedness up to 20 percent of the aggregate amount of long-term general obligation bonds outstanding. The state had outstanding \$7,344,565,000 variable rate general obligation bonds (which includes the economic recovery bonds), representing about 15.0 percent of the state’s total outstanding general obligation bonds as of October 1, 2006.

#### *New General Obligation Bond Measures Approved on November 7*

In response to the Governor’s proposal for a \$220 billion infrastructure investment plan, which would have used \$68 billion in new general obligation bonds, the Legislature approved four bond measures, totaling approximately \$37.3 billion, which were all approved by the voters at the November 7, 2006 general election. See "CURRENT STATE BUDGET – Strategic Growth Plan" below. These four measures are for the following programs:

--- \$19,925,000,000 for transportation improvements, air quality and port security (Proposition 1B)

--- \$10,416,000,000 for K-12 school modernization and construction (\$7.3 billion), and higher education facilities (\$3.1 billion) (Proposition 1D)

--- \$4,090,000,000 for flood control and prevention, levee repair and similar costs (Proposition 1E)

--- \$2,850,000,000 for housing and related programs (Proposition 1C)

An initiative measure (Proposition 84) authorizing approximately \$5.4 billion of bonds for water quality, flood control, parks and similar facilities was also approved by the voters.

A \$9.95 billion bond measure for high speed rail projects was moved from the November 2006 general election until the 2008 general election.

### Commercial Paper Program

Pursuant to legislation enacted in 1995, voter-approved general obligation indebtedness may be issued either as long-term bonds or, for some but not all bond issues, as commercial paper notes. Commercial paper notes may be renewed or may be refunded by the issuance of long-term bonds. The state issues long-term general obligation bonds from time to time to retire its general obligation commercial paper notes. Commercial paper notes are deemed outstanding upon authorization by the respective finance committees, whether or not such notes are actually issued. Pursuant to the terms of the bank credit agreement presently in effect, the general obligation commercial paper program may have up to \$1.5 billion in aggregate principal and interest commitments at any time. This amount may be increased or decreased in the future. As of October 1, 2006, the finance committees had authorized the issuance of up to \$18,108,127,000 of commercial paper notes and, as of that date, \$703,285,000 aggregate principal amount of general obligation commercial paper notes were issued. See “STATE DEBT TABLES” for information on the current outstanding amount of commercial paper notes.

### Lease-Purchase Obligations

In addition to general obligation bonds, the state builds and acquires capital facilities through the use of lease-purchase borrowing. Under these arrangements, the State Public Works Board, another state or local agency or a joint powers authority issues bonds to pay for the construction of facilities such as office buildings, university buildings or correctional institutions. These facilities are leased to a state agency or the University of California under a long-term lease that provides the source of payment of the debt service on the lease-purchase bonds. In some cases, there is not a separate bond issue, but a trustee directly creates certificates of participation in the state’s lease obligation, which are then marketed to investors. Under applicable court decisions, such lease arrangements do not constitute the creation of “indebtedness” within the meaning of the State Constitutional provisions that require voter approval. For purposes of this Appendix A and the tables under “STATE DEBT TABLES,” “lease-purchase obligation” or “lease-purchase financing” means principally bonds or certificates of participation for capital facilities where the rental payments providing the security are a direct or indirect charge against the General Fund and also includes revenue bonds for a state energy efficiency program secured by payments made by various state agencies under energy service contracts. Certain of the lease-purchase financings are supported by special funds rather than the General Fund. See “STATE FINANCES—Sources of Tax Revenue—Special Fund Revenues.” The tables under “STATE DEBT TABLES” do not include equipment leases or leases which were not sold, directly or indirectly, to the public capital markets. The state had \$7,687,328,179 General Fund-supported lease-purchase obligations outstanding as of October 1, 2006. The State Public Works Board, which is authorized to sell lease revenue bonds, had \$3,208,024,407 authorized and unissued as of October 1, 2006. In addition, as of that date, certain joint powers authorities were authorized to issue approximately \$81,000,000 of revenue bonds to be secured by state leases.

### Non-Recourse Debt

Certain state agencies and authorities issue revenue obligations for which the General Fund has no liability. Revenue bonds represent obligations payable from state revenue-producing enterprises and projects, which are not payable from the General Fund, and conduit obligations payable only from revenues paid by private users of facilities financed by the revenue bonds. The enterprises and projects include transportation projects, various public works projects, public and private educational facilities (including the California State University and University of California systems), housing, health facilities and pollution control facilities. State agencies and authorities had \$48,272,400,556 aggregate principal amount of revenue bonds and notes which are non-recourse to the General Fund outstanding as of

June 30, 2006, as further described in the table “State Agency Revenue Bonds and Conduit Financing” under “STATE DEBT TABLES.”

Detailed information regarding the state’s long-term debt appears in the section “STATE DEBT TABLES.”

### **Pension Obligation Bonds**

Pursuant to the California Pension Restructuring Bond Act of 2004, Government Code Section 16940, et seq. (the “Restructuring Bond Act”), the state proposed to issue pension obligation bonds to make future contributions to the California Public Employees’ Retirement System (“CalPERS”). The payment of the debt service on the pension obligation bonds would be payable from the General Fund.

Pursuant to the Restructuring Bond Act, the Pension Obligation Bond Committee (the “Committee”) authorized the issuance of bonds to pay a portion of the state’s pension obligation for fiscal year 2004-05 or a subsequent fiscal year. The Committee initiated a validation action seeking court determination that the bonds would not be in violation of the Constitutional debt limit because the proceeds of the bonds would be used to pay the state’s employer contribution obligation to CalPERS, which is an “obligation imposed by law.” The validation action was challenged in the court by the Pacific Legal Foundation, and this legal challenge prevented the issuance of any pension obligation bonds in time to pay the pension contribution during either fiscal year 2004-05 or fiscal year 2005-06. After a trial in the Sacramento County Superior Court, the judge ruled on November 15, 2005 that the bonds were not valid. The Committee has filed a notice of appeal and briefing is underway. The Administration has not included any pension obligation bonds in the 2006 Budget Act, but if the litigation is successful, such bonds can be issued in the future. See “LITIGATION – Matter Seeking Validation of Pension Obligation Bonds.”

### **Economic Recovery Bonds**

The California Economic Recovery Bond Act (“Proposition 57”) was approved by the voters at the statewide primary election on March 2, 2004. Proposition 57 authorizes the issuance of up to \$15 billion in economic recovery bonds to finance the negative General Fund reserve balance as of June 30, 2004, and other General Fund obligations undertaken prior to June 30, 2004. Repayment of the economic recovery bonds is secured by a pledge of revenues from a one-quarter cent increase in the state’s sales and use tax starting July 1, 2004. In addition, as voter-approved general obligation bonds, the economic recovery bonds are secured by the state’s full faith and credit. However, moneys in the General Fund will only be used in the event the dedicated sales and use tax revenue is insufficient to repay the bonds.

The state has issued \$10.896 billion principal amount of economic recovery bonds, resulting in the deposit of net proceeds to the General Fund of approximately \$11.254 billion during the 2003-04 fiscal year (of which, for budgetary purposes, approximately \$9.242 billion was applied to the 2002-03 fiscal year and approximately \$2.012 billion was applied to offset fiscal year 2004-05 General Fund expenditures). The state may issue the remainder of authorized economic recovery bonds at any time in the future, but the 2006 Budget Act assumes no economic recovery bonds will be issued in fiscal year 2006-07.

Three different sources of funds are required to be applied to the early retirement (generally by purchase or redemption) of economic recovery bonds: (i) all proceeds from this quarter cent sales tax in excess of the amounts needed, on a semi-annual basis, to pay debt service and other required costs of the bonds, (ii) all proceeds from the sale of surplus state property, and (iii) fifty percent of each annual

deposit, up to \$5 billion in the aggregate, of future deposits in the reserve fund created by the California Balanced Budget Act (see “THE BUDGET PROCESS – Constraints on the Budget Process – Proposition 58” below). Funds from sources (i) and (ii) above were used for early retirement of approximately \$623 million of bonds during fiscal year 2005-06. The state has announced that as of June 30, 2006, there was approximately \$343 million of excess sales tax revenues which will be used to retire economic recovery bonds during fiscal year 2006-07. Pursuant to the California Balanced Budget Act, the 2006 Budget Act includes \$472 million which was transferred from the reserve created under Proposition 58, and which will also be used to retire economic recovery bonds.

### **Tobacco Settlement Revenue Bonds**

In 1998 the state signed a settlement agreement (the “Master Settlement Agreement” or “MSA”) with the four major cigarette manufacturers (the “participating manufacturers” or “PMs”). Under the MSA, the participating manufacturers agreed to make payments to the state in perpetuity, which payments amount to approximately \$25 billion (subject to adjustments) over the first 25 years. Under a separate Memorandum of Understanding, half of the payments made by the cigarette manufacturers will be paid to the state and half to local governments (all counties and the cities of San Diego, Los Angeles, San Francisco and San Jose). The specific amount to be received by the state and local governments is subject to adjustment. Details in the MSA allow reduction of the manufacturers’ payments for decreases in cigarette shipment volumes by the settling manufacturers, payments owed to certain “Previously Settled States” and certain types of offsets for disputed payments, among other things. However, settlement payments are adjusted upward each year by at least 3 percent for inflation, compounded annually.

Chapter 414, Statutes of 2002, enacted Government Code Sections 63049 to 63049.5 (the “Tobacco Securitization Law”), which authorized the establishment of a special purpose trust to purchase those assets. The bill also authorized that entity to issue revenue bonds secured by the tobacco settlement revenues received beginning in the 2003–04 fiscal year. An initial sale of 56.57 percent of the state’s tobacco settlement revenues producing \$2.485 billion in proceeds was completed in January 2003 (Series 2003A).

A second sale of the remaining 43.43 percent of the state’s tobacco settlement revenues, which produced \$2.264 billion in proceeds, was completed in September 2003 (“Series 2003B”). Chapter 225, Statutes of 2003, amended the Tobacco Securitization Law to require the Governor to request an appropriation in the annual Budget Act to pay debt service and other related costs of the tobacco settlement revenue bonds secured by the second (and only the second) sale of tobacco settlement revenues when such tobacco settlement revenues are insufficient therefor. The Legislature is not obligated to make any such requested appropriation.

In August, 2005, the Series 2003B Bonds were refinanced (“Series 2005A”), retaining substantially all of the covenants of the original issue, including the covenant regarding the request for a General Fund appropriation in the event tobacco settlement revenues fall short. In return for providing this covenant, the state was paid a credit enhancement fee of \$525 million as part of the refinancing. See “PRIOR FISCAL YEAR’S BUDGETS – 2005 Budget Act – Financial Instruments.” Legislation to authorize the refunding of the Series 2003A Bonds has been passed by the Legislature and signed by the Governor, to become effective on January 1, 2007. The refunding is expected to yield approximately \$900 million to offset the General Fund cost for the initial years of the litigation settlement related to the 2004-05 suspension of the Proposition 98 guarantee. See “STATE FINANCES – Proposition 98.”

In early 2006, the participating manufacturers asserted that they had lost market share in 2003 to the non-participating manufacturers (“NPMs”). After analysis by a verification agent, that assertion was confirmed. As such, the participating manufacturers are authorized to withhold up to three times the



amount of lost market share until such time as it is proven that the various states diligently enforced their model statutes that govern the NPMs. As a result, the amount of tobacco settlement revenues received by the state was reduced this year by \$50.9 million. Nevertheless, the amount of tobacco settlement revenues received were still in excess of the required debt service payments. Therefore, it is anticipated that the need to invoke the provisions included in the state's budget for Series 2005A is unlikely and there will be no impact to the General Fund for the 2006-07 fiscal year. Furthermore, the Series 2005A Bonds have reserve funds in excess of one year's debt service payments, which would be used before General Fund moneys. A similar filing has been made by the PMs for the 2004 fiscal year but it is anticipated that, likewise, there will be no impact to the General Fund. The State Attorney General is working, in tandem with the other States Attorney General, under the terms of the MSA to compel the PMs to pay given that the state has been enforcing the statutes as required in the MSA.

Tobacco settlement revenue bonds are neither general nor legal obligations of the state or any of its political subdivisions and neither the faith and credit nor the taxing power nor any other assets or revenues of the state or of any political subdivision is or shall be pledged to the payment of any such bonds.

### **Cash Flow Borrowings**

As part of its cash management program, the state has regularly issued short-term obligations to meet cash flow needs. The state has issued revenue anticipation notes ("Notes" or "RANs") in 19 of the last 20 fiscal years to partially fund timing differences between receipts and disbursements, as the majority of General Fund revenues are received in the last part of the fiscal year. By law, RANs must mature prior to the end of the fiscal year of issuance. If additional external cash flow borrowings are required, the state has issued revenue anticipation warrants ("RAWs"), which can mature in a subsequent fiscal year. See "STATE FINANCES—State Warrants." RANs and RAWs are both payable from any "Unapplied Money" in the General Fund of the state on their maturity date, subject to the prior application of such money in the General Fund to pay Priority Payments. "Priority Payments" are payments as and when due to: (i) support the public school system and public institutions of higher education (as provided in Section 8 of Article XVI of the Constitution of the State), (ii) pay principal of and interest on general obligation bonds and general obligation commercial paper notes of the state, (iii) provide reimbursement from the General Fund to any special fund or account to the extent such reimbursement is legally required to be made to repay borrowings therefrom pursuant to California Government Code Sections 16310 or 16418; and (iv) pay state employees' wages and benefits, state payments to pension and other state employee benefit trust funds, state Medi-Cal claims, and any amounts determined by a court of competent jurisdiction to be required to be paid with state warrants that can be cashed immediately. See "STATE FINANCES" below.

The following table shows the amount of RANs and RAWs issued in the past five fiscal years. The state issued \$1.5 billion of RANs in October, 2006 in order to maintain adequate reserves to manage the state's cash flow requirements during fiscal year 2006-07. This was the smallest state RAN borrowing since 2000-01.

**TABLE 1**

**State of California Revenue Anticipation Notes and Warrants Issued  
Fiscal Years 2001-02 to 2006-07**

<b>Fiscal Year</b>	<b>Type</b>	<b>Principal Amount (Billions)</b>	<b>Date of Issue</b>	<b>Maturity Date</b>
2001-02	Notes Series A-C	\$5.70	October 4, 2001	June 28, 2002
	RAWs Series A	1.50	June 24, 2002	October 25, 2002
	RAWs Series B	3.00	June 24, 2002	November 27, 2002
	RAWs Series C	3.00	June 24, 2002	January 30, 2003 <sup>†</sup>
2002-03	Notes Series A and C	6.00	October 16, 2002	June 20, 2003
	Notes Series B and D	3.00	October 16, 2002	June 27, 2003
	Notes Series E – G	3.50	November 6, 2002	June 20, 2003
	RAWs Series A and B	10.965	June 18, 2003	June 16, 2004
2003-04	Notes	3.00	October 28, 2003	June 23, 2004
2004-05	Notes Series A – D	6.00	October 6, 2004	June 30, 2005
2005-06	Notes	3.00	November 10, 2005	June 30, 2006
2006-07	Notes	1.50	October 3, 2006	June 29, 2007

<sup>†</sup> Called by the State Controller and paid on November 27, 2002.

Source: State of California, Office of the State Treasurer.

## STATE FINANCES

### The General Fund

The moneys of the state are segregated into the General Fund and over 900 other funds, including special, bond and trust funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the investment of state moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major revenue sources of the state. For additional financial data relating to the General Fund, see the financial statements incorporated in or attached to this APPENDIX A. See “FINANCIAL STATEMENTS.” The General Fund may be expended as a consequence of appropriation measures enacted by the Legislature and approved by the Governor (including the annual Budget Act), as well as appropriations pursuant to various constitutional authorizations and initiative statutes.

### The Special Fund for Economic Uncertainties

The Special Fund for Economic Uncertainties (“SFEU”) is funded with General Fund revenues and was established to protect the state from unforeseen revenue reductions and/or unanticipated expenditure increases. The State Controller may transfer amounts in the SFEU to the General Fund as necessary to meet cash needs of the General Fund and such transfers are characterized as “loans.” The State Controller is required to return moneys so transferred without payment of interest as soon as there are sufficient moneys in the General Fund. At the end of each fiscal year, the State Controller is required to transfer from the SFEU to the General Fund any amount necessary to eliminate any deficit in the General Fund.

The legislation creating the SFEU (Government Code Section 16418) contains a continuous appropriation from the General Fund authorizing the State Controller to transfer to the SFEU, as of the end of each fiscal year, the lesser of (i) the unencumbered balance in the General Fund and (ii) the difference between the state's "appropriations subject to limitation" for the fiscal year then ended and its "appropriations limit" as defined in Section 8 of Article XIII B of the State Constitution and established in the Budget Act for that fiscal year, as jointly estimated by the Legislative Analyst's Office and the Department of Finance. For a further description of Article XIII B, see "State Appropriations Limit." In certain circumstances, moneys in the SFEU may be used in connection with disaster relief.

For budgeting and accounting purposes, any appropriation made from the SFEU is deemed an appropriation from the General Fund. For year-end reporting purposes, the State Controller is required to add the balance in the SFEU to the balance in the General Fund so as to show the total moneys then available for General Fund purposes. Under Proposition 58, the state will also have a second budgetary reserve, called the Budget Stabilization Account. See "THE BUDGET PROCESS – Constraints on the Budget Process – Proposition 58 (Balanced Budget Amendments)."

See Table 2 and Table 17 for information concerning the recent balances in the SFEU and projections of the balances for the previous and current fiscal years. As in any year, the Budget Act and related trailer bills are not the only pieces of legislation which appropriate funds. Other factors, including re-estimates of revenues and expenditures, existing statutory requirements and additional legislation introduced and passed by the Legislature may impact the fiscal year-end balance in the SFEU.

### **Inter-Fund Borrowings**

Inter-fund borrowing is used to meet temporary imbalances of receipts and disbursements in the General Fund. In the event the General Fund is or will be exhausted, the State Controller is required to notify the Governor and the Pooled Money Investment Board (the "PMIB," comprised of the State Director of Finance, the State Treasurer and the State Controller). The Governor may then order the State Controller to direct the transfer of all or any part of the moneys not needed in special funds to the General Fund, as determined by the PMIB. All money so transferred must be returned to the special fund from which it was transferred as soon as there is sufficient money in the General Fund to do so. Transfers cannot be made which will interfere with the objective for which such special fund was created, or from certain specific funds. When moneys transferred to the General Fund in any fiscal year from any special fund pursuant to the inter-fund borrowing mechanism exceed ten percent of the total additions to such special fund as shown in the statement of operations of the preceding fiscal year as set forth in the Budgetary (Legal Basis) annual report of the State Controller, interest must be paid on such excess at a rate determined by the PMIB to be the current earning rate of the Pooled Money Investment Account.

As of October 31, 2006, there were \$4.883 billion of loans from the SFEU and other internal sources to the General Fund. See EXHIBIT 2 – "STATE CONTROLLER'S STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS, JULY 1, 2006-OCTOBER 31, 2006 (UNAUDITED)."

Any determination of whether a proposed borrowing from one of the special funds is permissible must be made with regard to the facts and circumstances existing at the time of the proposed borrowing. The State Attorney General has identified certain criteria relevant to such a determination. For instance, amounts in the special funds eligible for inter-fund borrowings are legally available to be transferred to the General Fund if a reasonable estimate of expected General Fund revenues, based upon legislation already enacted, indicates that such transfers can be paid from the General Fund promptly if needed by the special funds or within a short period of time if not needed. In determining whether this requirement has been met, the Attorney General has stated that consideration may be given to the fact that General

Fund revenues are projected to exceed expenditures entitled to a higher priority than payment of internal transfers, i.e., expenditures for the support of the public school system and public institutions of higher education and the payment of debt service on general obligation bonds of the state.

At the November 1998 election, voters approved Proposition 2. This proposition requires the General Fund to repay loans made from certain transportation special accounts (such as the State Highway Account) at least once per fiscal year, or up to 30 days after adoption of the annual Budget Act. Since the General Fund may reborrow from the transportation accounts any time after the annual repayment is made, the proposition does not have any adverse impact on the state's cash flow.

In addition to temporary inter-fund borrowings described in this section, budgets enacted in the current and past fiscal years have included other transfers and long-term loans from special funds to the General Fund. In some cases, such loans and transfers have the effect of reducing internal borrowable resources.

The following chart shows internal borrowable resources available for temporary loans to the General Fund on June 30 of each of the fiscal years 2002-03 through 2005-06 and estimates, as of June 30, 2006, for fiscal year 2006-07. See also EXHIBIT 2 – "STATE CONTROLLER'S STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS, JULY 1, 2006 – OCTOBER 31, 2006 (UNAUDITED)."

**TABLE 2**  
**Internal Borrowable Resources**  
**(Cash Basis)**  
**(Millions)**

	<u>2003<sup>(a)</sup></u>	<u>2004<sup>(b)</sup></u>	<u>2005</u>	<u>2006</u>	<u>2007<sup>(c)</sup></u>
Available Internal Borrowable Resources	\$10,401.5	\$9,951.3	\$10,005.3	\$11,708.9	\$15,224.4
Outstanding Loans					
From Special Fund for Economic Uncertainties and Budget Stabilization Account	-0-	-0-	-0-	-0-	1,029.3
From Special Funds and Accounts	-0-	-0-	-0-	-0-	-0-
Total Outstanding Internal Loans	-0-	-0-	-0-	-0-	1,029.3
Unused Internal Borrowable Resources	\$10,401.5	\$9,951.3	\$10,005.3	\$11,708.9	\$14,195.2

(a) At June 30, 2003, the state also had \$10.965 billion of outstanding external borrowings in the form of revenue anticipation warrants.

(b) Includes the receipt of \$11.254 billion of economic recovery bond proceeds to the General Fund resulting from the issuance of three series of economic recovery bonds.

(c) Department of Finance estimates as of June 30, 2006.

Source: State of California, Department of Finance. Information for the fiscal years ended June 30, 2003 through June 30, 2005, are actual figures.

## **State Warrants**

No money may be drawn from the State Treasury except upon a warrant duly issued by the State Controller. The State Controller is obligated to draw every warrant on the fund out of which it is payable for the payment of money directed by state law to be paid out of the State Treasury; however, a warrant may not be drawn unless authorized by law and unless unexhausted specific appropriations provided by law are available to meet it. State law provides two methods for the State Controller to respond if the General Fund has insufficient “Unapplied Money” available to pay a warrant when it is drawn, referred to generally as “registered warrants” and “reimbursement warrants.” “Unapplied Money” consists of money in the General Fund for which outstanding warrants have not already been drawn and which would remain in the General Fund if all outstanding warrants previously drawn and then due were paid subject to the prior application of such money to obligations of the state with a higher priority. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS—Cash Flow Borrowings.” Unapplied Money may include moneys transferred to the General Fund from the SFEU and internal borrowings from state special funds (to the extent permitted by law). See “STATE FINANCES—The Special Fund for Economic Uncertainties” and “—Inter-Fund Borrowings.”

### *Registered Warrants*

If a warrant is drawn on the General Fund for an amount in excess of the amount of Unapplied Money in the General Fund, after deducting from such Unapplied Money the amount, as estimated by the State Controller, required by law to be set apart for obligations having priority over obligations to which such warrant is applicable, the warrant must be registered by the State Treasurer on the reverse side as not paid because of the shortage of funds in the General Fund. The State Controller then delivers such a “registered warrant” to persons or entities (e.g., suppliers and local governments) otherwise entitled to receive payments from the state. A registered warrant bears interest at a rate designated by the PMIB up to a maximum of five percent per annum or at a higher rate if issued for an unpaid revenue anticipation note or in connection with some form of credit enhancement. Registered warrants may or may not have a fixed maturity date. Registered warrants that have no fixed maturity date, and registered warrants that bear a maturity date but, for lack of Unapplied Moneys, were not paid at maturity, are paid, together with all interest due, when the State Controller, with the approval of the PMIB, determines payment will be made. The State Controller then notifies the State Treasurer, who publishes a notice that the registered warrants in question are payable. The duties of the State Controller and the PMIB are ministerial in nature, and the State Controller and the PMIB may not legally refuse to pay the principal of or interest on any registered warrants on any date Unapplied Moneys are available in the General Fund after all priority payments have been made on that date.

### *Reimbursement Warrants*

In lieu of issuing individual registered warrants to numerous creditors, state law provides an alternative procedure whereby the Governor, upon request of the State Controller, may authorize utilizing the General Cash Revolving Fund in the State Treasury to borrow from other state special funds to meet payments authorized by law. The State Controller may then issue “reimbursement warrants” in the financial market at competitive bid to reimburse the General Cash Revolving Fund, thereby increasing cash resources for the General Fund to cover required payments. The General Cash Revolving Fund exists solely to facilitate the issuance of reimbursement warrants. Reimbursement warrants may have a fixed maturity date.

The principal of and interest on reimbursement warrants must be paid by the State Treasurer on their respective maturity dates from any Unapplied Money in the General Fund and available for such payment. In the event that Unapplied Money is not available for payment on the respective maturity dates

of reimbursement warrants, and refunding warrants (see “—Refunding Warrants”) have not been sold at such times as necessary to pay such reimbursement warrants, such reimbursement warrants will be paid, together with all interest due thereon (including interest accrued at the original interest rate after the maturity date), at such times as the State Controller, with the approval of the PMIB, may determine.

The state has issued reimbursement warrants on several occasions in order to meet its cash needs when state revenues were reduced because of an economic recession, and the state incurred budget deficits. The state most recently issued reimbursement warrants in June 2002 and in June 2003.

### Refunding Warrants

If there is not sufficient Unapplied Money in the General Fund to pay maturing reimbursement warrants, the State Controller is authorized under state law, with the written approval of the State Treasurer, to offer and sell a new issue of reimbursement warrants as refunding warrants to refund the prior, maturing reimbursement warrants. Proceeds of such refunding warrants must be used exclusively to repay the maturing warrants. In all other respects, refunding warrants have the same legal status and provisions as reimbursement warrants, as described above.

### **Sources of Tax Revenue**

The following is a summary of the state’s major revenue sources. Further information on state revenues is contained under “CURRENT STATE BUDGET” and “STATE FINANCES—Recent Tax Receipts.” See Table 4 entitled “Comparative Yield of State Taxes—All Funds, 2001–02 Through 2006–07” for a comparison, by amount received, of the sources of the state’s tax revenue.

All revenue proposals included in the 2006-07 Governor’s Budget were adopted except for the proposal to conform to federal tax treatment of Health Savings Accounts.

Chapter 226, Statutes of 2004, created a personal income tax, corporate tax, and sales and use tax amnesty program for 2002 and prior tax years. Penalties were waived for taxpayers who applied for amnesty during the amnesty period of February 1, 2005 to March 31, 2005. Although taxpayers had to apply within this time frame, taxpayers had until the end of May 2005 to submit their tax returns and pay amounts owed. At the conclusion of amnesty, taxpayers who could have applied for amnesty but did not are subject to higher penalties if found to owe additional amounts for amnesty years. The amnesty program is estimated to result in a net multi-year General Fund revenue gain of \$380 million. See “PRIOR FISCAL YEARS’ BUDGETS – 2004 Budget Act – Tax Amnesty Program” below.

Four initiative propositions on the November 2006 election ballot would, in each case, have increased an existing tax or created a new tax, and dedicated such tax revenue for certain specified purposes. All four measures were defeated at the election.

### Personal Income Tax

The California personal income tax, which accounts for a significant portion of General Fund tax revenues, is closely modeled after the federal income tax law. It is imposed on net taxable income (gross income less exclusions and deductions), with rates ranging from 1.0 percent to 9.3 percent. The personal income tax is adjusted annually by the change in the consumer price index to prevent taxpayers from being pushed into higher tax brackets without a real increase in income. Personal, dependent and other credits are allowed against the gross tax liability. In addition, taxpayers may be subject to an alternative minimum tax (“AMT”), which is much like the federal AMT. The personal income tax structure is

considered to be highly progressive. For example, the Franchise Tax Board indicates that the top 1 percent of taxpayers paid 42.7 percent of the total personal income tax in tax year 2004.

Proposition 63, approved by the voters in the November 2004 election, imposes a 1 percent surcharge on taxpayers with taxable income over \$1 million, beginning with the 2005 tax year. The proceeds of the tax surcharge are required to be used to expand county mental health programs.

Taxes on capital gains realizations and stock options, which are largely linked to stock market performance, can add a significant dimension of volatility to personal income tax receipts. Capital gains and stock option tax receipts have accounted for as much as 24.7 percent and as little as 7.3 percent of General Fund revenues in the last ten years. The 2006-07 May Revision estimates that capital gains and stock option tax receipts will account for 13.2 percent of General Fund revenue in 2005-06 and 13.6 percent of General Fund revenue in 2006-07. See “CURRENT STATE BUDGET—Economic Assumptions.”

### Sales Tax

The sales tax is imposed upon retailers for the privilege of selling tangible personal property in California. Most retail sales and leases are subject to the tax. However, exemptions have been provided for certain essentials such as food for home consumption, prescription drugs, gas delivered through mains and electricity. Other exemptions provide relief for a variety of sales ranging from custom computer software to aircraft.

As of January 1, 2006, the breakdown of the base state and local sales tax rate of 7.25 percent is as follows:

- 5 percent imposed as a state General Fund tax;
- 0.5 percent dedicated to local governments for health and welfare program realignment (Local Revenue Fund);
- 0.5 percent dedicated to local governments for public safety services (Local Public Safety Fund);
- 1 percent local tax imposed under the Uniform Local Sales and Use Tax Law, with 0.25 percent dedicated to county transportation purposes and 0.75 percent for city and county general-purpose use; and
- 0.25 percent deposited into the Fiscal Recovery Fund to repay the state’s economic recovery bonds (the “Special Sales Tax”).

Existing law provides that 0.25 percent of the basic 5 percent state tax rate may be suspended in any calendar year upon certification by the Director of Finance by November 1 in any year in which both of the following occur: (1) the General Fund reserve (excluding the revenues derived from the 0.25 percent Special Sales Tax) is expected to exceed 3 percent of revenues in that fiscal year (excluding the revenues derived from the 0.25 percent Special Sales Tax) and (2) actual revenues for the period May 1 through September 30 equal or exceed the May Revision forecast. The 0.25 percent rate will be reinstated the following year if the Director of Finance subsequently determines conditions (1) or (2) above are not met for that fiscal year. The Department of Finance estimates that the reserve level will be insufficient to trigger a reduction for calendar year 2007. See “CURRENT STATE BUDGET—

Summary of State Revenues and Expenditures” for a projection of the fiscal year 2006-07 General Fund reserve.

Existing law provides that the Special Sales Tax will be collected until the first day of the calendar quarter at least 90 days after the Director of Finance certifies that all economic recovery bonds and related obligations have been paid or retired or provision for their repayment has been made or enough sales taxes have been collected to pay all economic recovery bonds and related obligations to final maturity. At such time the Special Sales Tax will terminate and the city and county portion of taxes under the Uniform Local Sales and Use Tax will be automatically increased by 0.25 percent.

Senate Constitutional Amendment No. 4, approved by the voters as Proposition 1A in the November 2004 election, amended the state Constitution to, among other things, reduce the Legislature’s authority over local government revenue sources by restricting the state from lowering the local sales tax rate or changing the allocation of local sales tax revenues without meeting certain conditions. See “STATE FINANCES—Local Governments.”

### Corporation Tax

Corporation tax revenues are derived from the following taxes:

1. The franchise tax and the corporate income tax are levied at an 8.84 percent rate on profits. The former is imposed on corporations for the privilege of doing business in California, while the latter is imposed on corporations that derive income from California sources but are not sufficiently present to be classified as doing business in the state.

2. Banks and other financial corporations are subject to the franchise tax plus an additional tax at the rate of 2 percent on their net income. This additional tax is in lieu of personal property taxes and business license taxes.

3. The alternative minimum tax (“AMT”) is similar to that in federal law. In general, the AMT is based on a higher level of net income computed by adding back certain tax preferences. This tax is imposed at a rate of 6.65 percent.

4. A minimum franchise tax of up to \$800 is imposed on corporations subject to the franchise tax but not on those subject to the corporate income tax. New corporations are exempted from the minimum franchise tax for the first two years of incorporation.

5. Sub-Chapter S corporations are taxed at 1.5 percent of profits.

6. Fees paid by Limited Liability Companies, which account for 2.6 percent of revenue are considered “corporation taxes.” The constitutionality of these fees is currently being challenged in two separate state courts. Potential revenue losses are estimated at \$1.12 billion in 2007-08 and \$400 million annually beginning in 2008-09. See “LITIGATION – Tax Refund Cases.”

On February 23, 2004, the U.S. Supreme Court denied the Franchise Tax Board’s appeal requesting review of the decision in *Farmer Brothers Company v. Franchise Tax Board*, a tax refund case which involved the deductibility of corporate dividends. Potential revenue losses are estimated to total \$400 million over several fiscal years through 2007–08 (some revenue gains are expected in fiscal years after that). The revenue impact from this case is included in state budget projections for fiscal year 2006-07.



### Insurance Tax

The majority of insurance written in California is subject to a 2.35 percent gross premium tax. For insurers, this premium tax takes the place of all other state and local taxes except those on real property and motor vehicles. Exceptions to the 2.35 percent rate are certain pension and profit-sharing plans which are taxed at the lesser rate of 0.5 percent, surplus lines and nonadmitted insurance at 3 percent and ocean marine insurers at 5 percent of underwriting profits.

### Estate Tax; Other Taxes

The California estate tax is based on the state death tax credit allowed against the federal estate tax. The California estate tax is designed to pick up the maximum credit allowed against the federal estate tax return. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (the “Economic Growth and Tax Relief Reconciliation Act”) phases out the federal estate tax by 2010. As a consequence, the Economic Growth and Tax Relief Reconciliation Act resulted in the reduction of the state estate tax revenues by 25 percent in calendar year 2002, 50 percent in calendar year 2003, and 75 percent in calendar year 2004, and the elimination of the state estate tax beginning in calendar year 2005. The provisions of this federal act sunset after 2010. At that time, the federal estate tax will be reinstated along with the state’s estate tax, unless future federal legislation is enacted to make the provisions permanent. See Table 4 entitled “Comparative Yield of State Taxes—All Funds, 2001-02 Through 2006-07.”

Other General Fund major taxes and licenses include: Inheritance and Gift Taxes; Cigarette Taxes; Alcoholic Beverage Taxes; Horse Racing License Fees and Trailer Coach License Fees.

### Special Fund Revenues

The California Constitution and statutes specify the uses of certain revenue. Such receipts are accounted for in various special funds. In general, special fund revenues comprise three categories of income:

- Receipts from tax levies which are allocated to specified functions, such as motor vehicle taxes and fees and certain taxes on tobacco products.
- Charges for special services to specific functions, including such items as business and professional license fees.
- Rental royalties and other receipts designated for particular purposes (e.g., oil and gas royalties).

Motor vehicle related taxes and fees accounted for about 37 percent of all special fund revenues in fiscal year 2004-05. Principal sources of this income are motor vehicle fuel taxes, registration and weight fees and vehicle license fees. During fiscal year 2004-05, \$8.2 billion was derived from the ownership or operation of motor vehicles. About \$3.3 billion of this revenue was returned to local governments. The remainder was available for various state programs related to transportation and services to vehicle owners. For a discussion of Proposition 1A, approved by the voters in November 2004, which replaced vehicle license fees with increased property tax revenues, see “STATE FINANCES—Local Governments—Vehicle License Fee.”

### Taxes on Tobacco Products

As a result of Proposition 99, approved by the voters in 1988, and Proposition 10, approved by the voters in 1998, the state imposes an excise tax on cigarettes of 87 cents per pack and the equivalent rates on other tobacco products. Tobacco product excise tax revenues are earmarked as follows:

1. Fifty cents of the per-pack tax on cigarettes and the equivalent rate levied on non-cigarette tobacco products are deposited in the California Children and Families First Trust Fund and are allocated primarily for early childhood development programs.

2. Twenty-five cents of the per-pack tax on cigarettes and the equivalent rates levied on non-cigarette tobacco products are allocated to the Cigarette and Tobacco Products Surtax Fund. These funds are appropriated for anti-tobacco education and research, indigent health services, and environmental and recreation programs.

3. Ten cents of the per-pack tax is allocated to the state's General Fund.

4. The remaining two cents of the per-pack tax is deposited into the Breast Cancer Fund.

### **Recent Tax Receipts**

The following table shows the trend of major General Fund and total taxes per capita and per \$100 of personal income for the past five years and the current fiscal year.

**TABLE 3**

### **Recent Tax Receipts**

<b>Fiscal Year</b>	<b>Trend of State Taxes per Capita<sup>(a)</sup></b>		<b>Taxes per \$100 of Personal Income</b>	
	<b>General Fund</b>	<b>Total</b>	<b>General Fund</b>	<b>Total</b>
2001–02 .....	1,801.21	2,105.46	5.52	6.45
2002–03 .....	1,833.10	2,133.14	5.65	6.58
2003–04 .....	1,951.35	2,268.10	5.93	6.89
2004–05 <sup>(b)</sup> .....	2,193.70	2,568.87	6.34	7.43
2005–06 <sup>(c)</sup> .....	2,434.03	2,843.92	6.70	7.83
2006–07 <sup>(c)</sup> .....	2,467.83	2,906.42	6.48	7.63

<sup>(a)</sup> Data reflect population figures based on the 2000 Census.

<sup>(b)</sup> Preliminary.

<sup>(c)</sup> Estimated.

Source: State of California, Department of Finance.

The following table displays the actual and estimated revenues by major source for the last five years and the current fiscal year. This table shows taxes that provide revenue both to the General Fund and state special funds.

**TABLE 4**  
**Comparative Yield of State Taxes — All Funds**  
**2001–02 Through 2006–07**  
**(Modified Accrual Basis)**  
**(Thousands)**

<b>Year Ending June 30</b>	<b>Sales and Use<sup>(a)</sup></b>	<b>Personal Income</b>	<b>Corporation</b>	<b>Tobacco</b>	<b>Inheritance, Estate and Gift<sup>(b)</sup></b>	<b>Insurance</b>	<b>Alcoholic Beverages</b>	<b>Horse Racing</b>	<b>Motor Vehicle Fuel<sup>(c)</sup></b>	<b>Motor Vehicle Fees<sup>(d)</sup></b>
2002	26,004,521 <sup>(f)</sup>	33,051,107	5,333,030	1,102,806	890,627	1,595,846	292,627	42,247	3,295,903	3,836,795
2003	27,177,756 <sup>(f)</sup>	32,713,830	6,803,583	1,055,505	647,372	1,879,784	290,564	40,509	3,202,512	3,965,410
2004	28,948,622 <sup>(f)</sup>	36,398,983	7,019,216	1,081,588	397,848	2,114,980	312,826	42,143	3,324,883	4,415,126
2005	32,638,090 <sup>(f)</sup>	42,912,860	8,670,065	1,085,721	213,035	2,232,954	314,251	38,491	3,366,142	4,882,664
2006 <sup>(e)</sup>	31,721,666 <sup>(g)</sup>	50,740,000 <sup>(h)</sup>	10,484,000	1,065,915	0	2,247,000	315,000	38,235	3,397,987	5,090,728
2007 <sup>(e)</sup>	33,523,916 <sup>(g)</sup>	52,140,000 <sup>(h)</sup>	10,507,000	1,096,115	0	2,340,000	316,000	38,985	3,482,636	5,265,113

(a) Numbers include local tax revenue from the 0.5 percent rate increase dedicated to local governments for the state-local health and welfare program realignment program. The 0.5 percent rate is equivalent to about \$2.4 billion to \$2.7 billion per year. The figures also reflect a statutory 0.25 percent reduction that occurred only during calendar year 2001.

(b) The state estate tax is based on the state death tax credit allowed against the federal estate tax. As a result, the federal Economic Growth and Tax Relief Reconciliation Act progressively reduced the state estate tax in calendar years 2002 through 2004 and eliminates it beginning in calendar year 2005.

(c) Motor vehicle fuel tax (gasoline), use fuel tax (diesel and other fuels), and jet fuel.

(d) Registration and weight fees, motor vehicle license fees and other fees. Represents a reduction of vehicle license fee rate on July 1, 2001 from 1.3 percent of vehicle depreciable value to 0.65 percent. Effective July 1, 2005, the rate was reset at 0.65 percent.

(e) Estimated.

(f) The figures do not include voter approved local revenue, local city and county operations revenue (Bradley-Burns), or the 0.25 percent county transportation funds revenue. Figures do include the 0.5 percent Local Public Safety Fund revenue.

(g) Unlike the figures for fiscal years ending June 30, 2002 through June 30, 2005, these estimated figures do not include the 0.5 percent Local Public Safety Fund revenue. These estimated figures also do not include voter approved local revenue, local city and county operations revenue (Bradley-Burns), or the 0.25 percent county transportation funds revenue. Estimate for fiscal year 2005–06 includes \$1.383 billion and for fiscal year 2006–07 includes \$1.456 billion for a temporary one-quarter cent tax increase to be deposited in the Fiscal Recovery Fund and used for repayment of the economic recovery bonds. See “Sources of Tax Revenue—Sales Tax.”

(h) Includes the revenue estimate for a 1 percent surcharge on taxpayers with taxable income over \$1 million, with the proceeds funding mental health programs pursuant to Proposition 63.

NOTE: This table shows taxes that provide revenue both to the General Fund and state special funds. Also, some revenue sources are dedicated to local governments. This accounts for differences between the information in this table and Table 18.

Source: Fiscal years 2001–02 through 2004–05: State of California, Office of the State Controller.  
Fiscal years 2005–06 and 2006–07: State of California, Department of Finance.

## State Expenditures

The following table summarizes the major categories of state expenditures, including both General Fund and special fund programs.

**TABLE 5**  
**Governmental Cost Funds**  
**(Budgetary Basis)**  
**Schedule of Expenditures by Function and Character**  
**Fiscal Years 2000–01 to 2004–05**  
**(Thousands)**

	2000–01	2001–02	2002–03	2003–04	2004–05
Function					
Legislative, Judicial, Executive					
Legislative	\$ 262,370	\$ 265,312	\$ 276,462	\$ 284,894	\$ 408,426
Judicial <sup>(a)</sup>	1,478,710	1,633,518	2,524,446	2,634,409	2,881,680
Executive	1,352,128	1,371,891	1,283,297	1,329,557	1,362,268
State and Consumer Services	950,192	1,100,942	955,054	946,584	1,025,817
Business, Transportation and Housing					
Business and Housing	601,053	240,237	184,573	235,742	196,209
Transportation	4,417,139	6,052,926	3,712,133	6,077,810	6,819,308
Technology, Trade and Commerce <sup>(b)</sup>	140,833	81,832	50,335	10,262	0
Resources	3,349,003	2,284,269	1,993,957	2,100,200	2,232,498
Environmental Protection	869,539	993,144	762,052	749,988	788,805
Health and Human Services	24,204,531	26,563,743	27,420,865	26,793,410	30,223,891
Correctional Programs	4,952,927	5,242,369	5,614,849	5,246,381	6,769,319
Education					
Education–K through 12	28,720,596	28,078,228	27,611,356	28,696,655	32,118,886
Higher Education	9,655,954	9,945,193	9,951,749	9,487,413	9,985,180
Labor and Workforce Development <sup>(c)</sup>	N/A	N/A	250,616	239,051	319,984
General Government					
General Administration	1,294,587	2,475,564	1,830,280	3,580,718	1,745,492
Debt Service	2,270,649	2,432,942	2,067,815	2,103,756	3,390,653
Tax Relief	4,655,826	3,028,703	4,446,940	3,782,731	665,597
Shared Revenues	4,385,429	5,528,996	2,784,970	2,664,766	1,691,964
Brown vs. U.S. Dept. of Health and Human Services	–	96,000	–	–	–
Other Statewide Expenditures	635,475	476,170	526,863	825,833	(1,128,219)
Expenditure Adjustment for Encumbrances <sup>(d)</sup>	(1,943,208)	(681,856)	2,365,728	363,473	(1,038,273)
Credits for Overhead Services by General Fund	(197,343)	(251,575)	(288,871)	(326,928)	(329,796)
Statewide Indirect Cost Recoveries	(36,610)	(47,862)	(50,313)	(59,081)	(74,581)
<b>Total</b>	<b>\$92,019,780</b>	<b>\$96,910,686</b>	<b>\$96,275,156</b>	<b>\$97,767,624</b>	<b>\$100,055,108</b>
Character					
State Operations	\$24,850,286	\$27,994,343	\$26,241,065	\$28,208,541	\$28,783,825
Local Assistance	66,087,018	67,993,721	69,043,191	68,086,507	70,217,159
Capital Outlay	1,082,476	922,622	990,900	1,472,576	1,054,124
<b>Total</b>	<b>\$92,019,780</b>	<b>\$96,910,686</b>	<b>\$96,275,156</b>	<b>\$97,767,624</b>	<b>\$100,055,108</b>

(a) Included in this amount are the expenditures of the Trial Court Trust Fund. As of July 1, 2002, the Trial Court Trust Fund was reclassified to a Governmental Cost Fund from a Non-Governmental Cost Fund.

(b) As of January 2004, Technology, Trade and Commerce was abolished per Assembly Bill 1757 of 2003, Chapter 229. Funds that were abolished were transferred to the General Fund.

(c) Legislation was enacted effective January 1, 2003 which created a new agency function called the Labor and Workforce Development. Fiscal year 2002–03 figure reflects the expenditure for the entire fiscal year. The following agencies were transferred from General Government to this new function: the Employment Development Department, the California Workforce Investment Board, the Agricultural Labor Relations Board, and the Department of Industrial Relations.

(d) Expenditures for the State Highway Account (Fund 0042) and the Traffic Congestion Relief Fund (Fund 3007) are reported on a modified cash basis. This method of accounting eliminated all of the continuing appropriations in these two funds.

N/A – Not applicable

Source: State of California, Office of the State Controller.

## **State Appropriations Limit**

The state is subject to an annual appropriations limit imposed by Article XIII B of the State Constitution (the “Appropriations Limit”). The Appropriations Limit does not restrict appropriations to pay debt service on voter-authorized bonds.

Article XIII B prohibits the state from spending “appropriations subject to limitation” in excess of the Appropriations Limit. “Appropriations subject to limitation,” with respect to the state, are authorizations to spend “proceeds of taxes,” which consist of tax revenues, and certain other funds, including proceeds from regulatory licenses, user charges or other fees to the extent that such proceeds exceed “the cost reasonably borne by that entity in providing the regulation, product or service,” but “proceeds of taxes” exclude most state subventions to local governments, tax refunds and some benefit payments such as unemployment insurance. No limit is imposed on appropriations of funds which are not “proceeds of taxes,” such as reasonable user charges or fees and certain other non-tax funds.

There are various types of appropriations excluded from the Appropriations Limit. For example, debt service costs of bonds existing or authorized by January 1, 1979, or subsequently authorized by the voters, appropriations required to comply with mandates of courts or the federal government, appropriations for qualified capital outlay projects, appropriations for tax refunds, appropriations of revenues derived from any increase in gasoline taxes and motor vehicle weight fees above January 1, 1990 levels, and appropriation of certain special taxes imposed by initiative (e.g., cigarette and tobacco taxes) are all excluded. The Appropriations Limit may also be exceeded in cases of emergency.

The Appropriations Limit in each year is based on the Appropriations Limit for the prior year, adjusted annually for changes in state per capita personal income and changes in population, and adjusted, when applicable, for any transfer of financial responsibility of providing services to or from another unit of government or any transfer of the financial source for the provisions of services from tax proceeds to non-tax proceeds. The measurement of change in population is a blended average of statewide overall population growth, and change in attendance at local school and community college (“K-14”) districts. The Appropriations Limit is tested over consecutive two-year periods. Any excess of the aggregate “proceeds of taxes” received over such two-year period above the combined Appropriations Limits for those two years, is divided equally between transfers to K-14 districts and refunds to taxpayers.

The Legislature has enacted legislation to implement Article XIII B which defines certain terms used in Article XIII B and sets forth the methods for determining the Appropriations Limit. California Government Code Section 7912 requires an estimate of the Appropriations Limit to be included in the Governor’s Budget, and thereafter to be subject to the budget process and established in the Budget Act.

The following table shows the Appropriations Limit for fiscal years 2002-03 through 2006-07.

As of the release of the 2006 Budget Act, the Department of Finance projects the Appropriations Subject to the Limit to be \$58.823 billion and \$56.736 billion in fiscal years 2005-06 and 2006-07, respectively.

**TABLE 6****State Appropriations Limit  
(Millions)**

	<b>Fiscal Years</b>				
	<b>2002–03</b>	<b>2003–04</b>	<b>2004–05</b>	<b>2005–06</b>	<b>2006–07</b>
State Appropriations Limit	\$59,591	\$61,702	\$64,588	\$68,890	\$72,304
Appropriations Subject to Limit	(45,832)	(47,921)	(53,488)	(58,823)*	(56,736)*
Amount (Over)/Under Limit	\$13,759	\$13,781	\$11,100	\$10,067*	\$15,568*

\* Estimated/projected.

Source: State of California, Department of Finance.

**Proposition 98**

On November 8, 1988, the voters of the state approved Proposition 98, a combined initiative constitutional amendment and statute called the “Classroom Instructional Improvement and Accountability Act.” Proposition 98 changed state funding of public education below the university level and the operation of the State Appropriations Limit, primarily by guaranteeing K-14 education a minimum level of funding. Proposition 98 (as modified by Proposition 111, enacted on June 5, 1990) guarantees K-14 education the greater of: (a) in general, a fixed percentage of General Fund revenues (“Test 1”), (b) the amount appropriated to K-14 education in the prior year, adjusted for changes in state per capita personal income and enrollment (“Test 2”), or (c) a third test, which replaces Test 1 and Test 2 in any year that the percentage growth in per capita General Fund revenues from the prior year plus one half of one percent is less than the percentage growth in state per capita personal income (“Test 3”).

Legislation adopted prior to the end of the 1988–89 fiscal year implementing Proposition 98 determined the K-14 education’s funding guarantee under Test 1 to be 40.7 percent of General Fund tax revenues, based on 1986-87 appropriations. However, this percentage has since been adjusted to approximately 41.0 percent of 1986-87 appropriations to account for subsequent changes in the allocation of local property taxes, since these changes altered the share of General Fund revenues received by schools. The Proposition 98 guarantee has typically been calculated under Test 2. Under Test 3, however, schools receive the amount appropriated in the prior year adjusted for changes in enrollment and per capita General Fund revenues, plus 0.5 percent. If Test 3 is used in any year, the difference between Test 3 and Test 2 becomes a “credit” (called the “maintenance factor”) to schools and is paid to them in future years when per capita General Fund revenue growth exceeds per capita personal income growth.

The Proposition 98 guarantee is funded from two sources: local property taxes and the General Fund. Any amount not funded by local property taxes is funded by the General Fund. Thus, local property tax collections represent an offset to General Fund costs in a Test 2 or Test 3 year.

Proposition 98 also contains provisions for the transfer of certain state tax revenues in excess of the Article XIII B limit to K-14 education in Test 1 years when additional moneys are available. No such transfers are anticipated during fiscal year 2006-07. See “STATE FINANCES—State Appropriations Limit.”

The 2006 Budget Act reflects General Fund Proposition 98 expenditures in fiscal years 2004-05 through 2006-07, as outlined in the table below. The 2006 Budget Act includes no decreases for

declining growth (-0.26 percent) and provides full funding for COLA (5.92 percent) adjustments in 2006-07, and also reflects the deferral of Proposition 98 expenditures of \$1.283 billion from fiscal year 2004-05 to 2005-06, \$1.303 billion from fiscal year 2005-06 to 2006-07, and \$1.303 billion from fiscal year 2006-07 to 2007-08.

**TABLE 7**

**Proposition 98 Funding  
(\$ in Millions)**

	<b>2004-05</b>		<b>2005-06</b>		<b>2006-07</b>	<b>Change From Revised 2005-06</b>	
	<b>Enacted</b>	<b>Revised</b>	<b>Enacted</b>	<b>Revised</b>	<b>Enacted</b>	<b>Amount</b>	<b>Percent</b>
<b>K-12 Proposition 98</b>							
State General Fund .....	\$30,873	\$30,902	\$33,071	\$34,644	\$37,141	\$2,497	7.2%
Local property tax revenue	11,214	11,266	11,573	11,807	11,973	166	1.4
Subtotals <sup>(a)</sup> .....	\$42,087	\$42,168	\$44,644	\$46,451	\$49,114	\$2,663	5.7%
<b>Other Proposition 98</b>							
State General Fund .....	\$ 3,130	\$ 3,132	\$ 3,520	\$ 3,776	\$ 4,154	\$ 378	10.0%
Local property tax revenue	1,772	1,754	1,804	1,819	1,853	34	1.9
Subtotals <sup>(a)</sup> .....	\$4,902	\$4,886	\$5,324	\$5,595	\$6,007	\$ 412	7.4%
<b>Total Proposition 98</b>							
State General Fund .....	\$34,003	\$34,034	\$36,591	\$38,420	\$41,295	\$2,875	7.5%
Local property tax revenue	12,986	13,020	13,377	13,626	13,827	200	1.5
<b>Totals<sup>(a)</sup> .....</b>	<b>\$46,989</b>	<b>\$47,055</b>	<b>\$49,968</b>	<b>\$52,046</b>	<b>\$55,122</b>	<b>\$3,075</b>	<b>5.9%</b>

<sup>(a)</sup> Totals may not add due to rounding.

Source: State of California, Department of Finance

Proposition 98 permits the Legislature, by a two-thirds vote of both houses (on a bill separate from the Budget Act), and with the Governor's concurrence, to suspend the K-14 education's minimum funding guarantee for a one-year period. The amount of the suspension is added to the maintenance factor, the repayment of which occurs according to a specified State Constitutional formula, and eventually restores Proposition 98 funding to the level that would have been required in the absence of such a suspension. Therefore, suspending the minimum funding guarantee provides ongoing General Fund savings over multiple fiscal years until the maintenance factor is fully repaid.

Legislation related to the 2004 Budget Act suspended the Proposition 98 minimum guarantee. At the time the 2004 Budget Act was enacted, this suspension was estimated to be \$2.004 billion. This suspended amount was added to the existing maintenance factor, which was fully paid in 2005-06. However, subsequent growth in General Fund revenue has increased the estimated 2004-05 Proposition 98 guarantee calculation by an additional \$1.6 billion. This additional funding, along with approximately \$1.3 billion in 2005-06 were the subject of a lawsuit which has recently been settled (the *California Teachers Association* case). The terms agreed upon consist of retiring this approximately \$2.9 billion obligation beginning in 2007-08 with a \$300 million payment and then in annual payments of \$450 million beginning in 2008-09 until the full amount is paid. See "LITIGATION – Action Seeking Recalculation of Proposition 98 Minimum Funding Guarantee."

The settlement of the *California Teachers Association* case was ratified by legislation enacted in September, 2006 (Chapter 751, Statutes of 2006). In addition, legislation was approved to refinance the

Golden State Tobacco Securitization Corporation's Series 2003A Bonds, to become effective on January 1, 2007. The first \$900 million in additional funds expected to be raised from the refinancing will be used to offset initial costs of the *California Teachers Association* settlement. After estimated and proposed payments in 2005-06 and 2006-07, the total estimated maintenance factor balance will be \$71 million at the end of fiscal year 2006-07. This maintenance factor balance is required to be restored to the Proposition 98 budget over future years as explained above.

Proposition 98 appropriations for fiscal years 1995-96, 1996-97, 2002-03, and 2003-04 are cumulatively estimated to be \$1.4 billion below the amounts required by Proposition 98 for those years because of changes in various Proposition 98 factors applicable to those years. Chapter 216, Statutes of 2004, annually appropriates \$150 million per year beginning in fiscal year 2006-07, to repay these prior year Proposition 98 obligations. However, Chapter 491, Statutes of 2005, appropriated \$16.8 million toward these settle-up obligations during the 2005-06 fiscal year, and explicitly reduced the first Chapter 216 settle-up appropriation, from \$150 million to \$133.2 million for 2006-07. The 2006 Budget Act includes this appropriation along with a \$150 million prepayment of the 2007-08 allocation.

### **Local Governments**

The primary units of local government in California are the 58 counties, which range in population from 1,200 in Alpine County to approximately 10 million in Los Angeles County. Counties are responsible for the provision of many basic services, including indigent health care, welfare, jails, and public safety in unincorporated areas. There are also 478 incorporated cities in California and thousands of special districts formed for education, utilities, and other services. The fiscal condition of local governments has been constrained since Proposition 13, which added Article XIII A to the State Constitution ("Proposition 13"), was approved by California voters in 1978. Proposition 13 reduced and limited the future growth of property taxes and limited the ability of local governments to impose "special taxes" (those devoted to a specific purpose) without two-thirds voter approval. Proposition 218, another constitutional amendment enacted by initiative in 1996, further limited the ability of local governments to raise taxes, fees, and other exactions. Counties, in particular, have had fewer options to raise revenues than many other local government entities, while they have been required to maintain many services.

In the aftermath of Proposition 13, the state provided aid to local governments from the General Fund to make up some of the loss of property tax moneys, including assuming principal responsibility for funding K-12 schools and community colleges. During the recession of the early 1990s, the Legislature eliminated most of the remaining components of post-Proposition 13 aid to local government entities other than K-12 schools and community colleges by requiring cities and counties to transfer some of their property tax revenues to school districts. However, the Legislature also provided additional funding sources, such as sales taxes, and reduced certain mandates for local services funded by cities and counties. See "STATE FINANCES—Sources of Tax Revenue—Sales Tax" for a discussion of the impact of the economic recovery bond issuances on local sales taxes.

The 2004 Budget Act, related legislation and the enactment of Senate Constitutional Amendment No. 4 (described below) dramatically changed the state-local fiscal relationship. These constitutional and statutory changes implemented an agreement negotiated between the Governor and local government officials (the "state-local agreement") in connection with the 2004 Budget Act. One change relates to the reduction of the vehicle license fee ("VLF") rate from 2 percent to 0.65 percent of the market value of the vehicle. In order to protect local governments, which have previously received all VLF revenues, the reduction in VLF revenue to cities and counties from this rate change was replaced by an increase in the amount of property tax they receive.



As part of the state-local agreement, Senate Constitutional Amendment No. 4 was enacted by the Legislature and subsequently approved by the voters as Proposition 1A (“Proposition 1A”) at the November 2004 election. Proposition 1A amended the State Constitution to, among other things, reduce the Legislature’s authority over local government revenue sources by placing restrictions on the state’s access to local governments’ property, sales, and vehicle license fee revenues as of November 3, 2004. Beginning with fiscal year 2008–09, the state will be able to borrow up to 8 percent of local property tax revenues, but only if the Governor proclaims such action is necessary due to a severe state fiscal hardship, two-thirds of both houses of the Legislature approves the borrowing and the amount borrowed is required to be paid back within three years. The state also will not be able to borrow from local property tax revenues for more than two fiscal years within a period of 10 fiscal years, and only if previous borrowings have been repaid. In addition, the state cannot reduce the local sales tax rate or restrict the authority of the local governments to impose or change the distribution of the statewide local sales tax. Proposition 1A also prohibits the state from mandating activities on cities, counties or special districts without providing for the funding needed to comply with the mandates. Beginning in fiscal year 2005-06, if the state does not provide funding for the activity that has been determined to be mandated, the requirement on cities, counties or special districts to abide by the mandate would be suspended. In addition, Proposition 1A expanded the definition of what constitutes a mandate to encompass state action that transfers to cities, counties and special districts financial responsibility for a required program for which the state previously had partial or complete responsibility. The state mandate provisions of Proposition 1A do not apply to schools or community colleges or to mandates relating to employee rights. See “THE BUDGET PROCESS—Constraints on the Budget Process—Local Government Finance (Proposition 1A of 2004).”

#### *Vehicle License Fee*

Prior to enactment of the 2004 Budget Act, vehicle license fees were assessed in the amount of two percent of a vehicle’s depreciated market value for the privilege of operating a vehicle on California’s public highways. A program to offset (or reduce) a portion of the VLF paid by vehicle owners was established by Chapter 322, Statutes of 1998. Beginning January 1, 1999, a permanent offset of 25 percent of the VLF paid by vehicle owners became operative. Various pieces of legislation increased the amount of the offset in subsequent years to the existing statutory level of 67.5 percent of two percent (resulting in an effective rate of 0.65 percent). This level of offset provided tax relief of \$4.3 billion in fiscal year 2003–04.

In connection with the offset of the VLF, the Legislature authorized appropriations from the state General Fund to “backfill” the offset so that local governments, which receive all of the vehicle license fee revenues, would not experience any loss of revenues. The legislation that established the VLF offset program also provided that if there were insufficient General Fund moneys to fully “backfill” the VLF offset, the percentage offset would be reduced proportionately (i.e., the license fee payable by drivers would be increased) to assure that local governments would not be disadvantaged. In June 2003, the Director of Finance under the Davis Administration ordered the suspension of VLF offsets due to a determination that insufficient General Fund moneys would be available for this purpose, and, beginning in October 2003, VLF paid by vehicle owners were restored to the 1998 level. However, the offset suspension was rescinded by Governor Schwarzenegger on November 17, 2003, and offset payments to local governments resumed. Local governments received “backfill” payments totaling \$3.80 billion in fiscal year 2002–03 and \$3.1 billion in fiscal year 2003–04. In addition, the state-local agreement also provided for the repayment by August 2006 of the approximately \$1.2 billion that was not received by local governments from July to October of 2003, which is the time period between the suspension of the offsets and the implementation of higher fees.

Beginning in fiscal year 2004–05, the state-local agreement permanently reduced the VLF rate to 0.65 percent, and eliminated the General Fund offset program. The State Constitution, amended by the voter approval of Proposition 1A in the November 2004 election, codifies the obligation of the state to provide replacement revenues to local governments for revenues lost as a result of the decrease in VLF rate below the current level of 0.65 percent of the market value of the vehicle.

The 2005 Budget Act provided for the early repayment, in fiscal year 2005-06, of the whole \$1.2 billion in VLF backfill payments owed to local governments. This payment took place in August 2005. See “PRIOR FISCAL YEARS’ BUDGETS – 2005 Budget Act.”

### *Trial Courts*

Prior to legislation enacted in 1997, local governments provided the majority of funding for the state’s trial court system. The legislation consolidated the trial court funding at the state level in order to streamline the operation of the courts, provide a dedicated revenue source, and relieve fiscal pressure on the counties. The state’s trial court system will receive approximately \$2.4 billion and \$2.6 billion in state resources in fiscal years 2005–06 and 2006–07, respectively, and \$475 million in resources from the counties in each fiscal year.

### *Welfare System*

The entire statewide welfare system was changed in response to the change in federal welfare law enacted in 1996 (see “Welfare System”). Under the CalWORKs (defined below) program, counties are given flexibility to develop their own plans, consistent with state law, to implement the program and to administer many of its elements. Counties are still required to provide “general assistance” aid to certain persons who cannot obtain welfare from other programs.

### **Welfare System**

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104–193, the “Law”) fundamentally reformed the nation’s welfare system. The Law included provisions to: (i) convert Aid to Families with Dependent Children (“AFDC”), an entitlement program, to Temporary Assistance for Needy Families (“TANF”), a block grant program with lifetime time limits on TANF recipients, work requirements and other changes; (ii) deny certain federal welfare and public benefits to legal noncitizens (subsequent federal law has amended this provision), allow states to elect to deny additional benefits (including TANF) to legal noncitizens, and generally deny almost all benefits to illegal immigrants; and (iii) make changes in the Food Stamp program, including to reduce maximum benefits and impose work requirements. The TANF block grant formula under the Law is operative through September 30, 2010, as further described below.

Chapter 270, Statutes of 1997, embodies California’s response to the federal welfare systems. Effective January 1, 1998, California Work Opportunity and Responsibility to Kids (“CalWORKs”) replaced the former AFDC and Greater Avenues to Independence programs. Consistent with the federal law, CalWORKs contains time limits on the receipt of welfare aid, both lifetime as well as current period. The centerpiece of CalWORKs is the linkage of eligibility to work participation requirements.

Caseload under CalWORKs is projected to decrease by a modest amount in 2006-07. The revised CalWORKs caseload projections are 478,100 cases in fiscal year 2005-06 and 471,700 cases in fiscal year 2006-07. This still represents a major decline in caseload from the rapid growth of the early 1990s, when caseload peaked at 921,000 cases in fiscal year 1994–95. Since CalWORKs’ inception in January 1998, caseload has declined by over 35 percent.

California will continue to meet, but not exceed, the federally-required \$2.7 billion combined state and county maintenance of effort (“MOE”) requirement in fiscal years 2005-06 and 2006-07. In an effort to keep program expenditures within the TANF Block Grant and TANF MOE amounts and address the Administration’s objective to alleviate the structural deficit between the state’s revenues and expenditures, the 2005 Budget Act suspended the July 2005 and July 2006 CalWORKs grant cost-of-living adjustments. The 2006 Budget Act also maintains expenditures within available resources while continuing efforts to move people from welfare to work. The 2006 Budget Act reflects savings resulting from continued efforts to fully implement state welfare system measures initiated in 2004-05, an estimated decrease in 2005-06 child care expenditures, and implementation of several initiatives to improve the state’s work participation in response to TANF reauthorization, as further described below.

The federal Deficit Reduction Act of 2005 included legislation that reauthorized and extended the TANF program until September 30, 2010. The reauthorization legislation modifies countable work activities under TANF and applies new federal work participation rates to separate state programs. In addition, because reauthorization legislation effectively eliminates the state’s caseload reduction credit, the bulk of the CalWORKs caseload will be subject to the 50 percent work participation rate beginning in federal fiscal year 2007. Considerable improvement in work participation rates must be achieved to avoid federal penalties, which could cost the General Fund more than \$2 billion over a five-year period. While these penalties likely would not be assessed until after 2006-07, the 2006 Budget Act addresses the need to increase work participation rates through substantive program improvements that will support and engage more recipients in activities that lead to self-sufficiency. Major investments include (1) implementing the Pay for Performance county incentive program, (2) providing funding for counties to implement strategies to improve work participation rates based on local needs assessments, (3) increasing temporary shelter rates to prevent homelessness among CalWORKs recipients, (4) augmenting funding for CalWORKs employment services, child care services, and administrative activities, and (5) increasing the TANF reserve to address future changes or improvements to CalWORKs. A workgroup consisting of key stake holders is evaluating options for future program changes.

The 2006 Budget Act includes total CalWORKs-related expenditures of \$7.1 billion for fiscal year 2006-07, compared to \$6.7 billion for fiscal year 2005-06. Both years include an augmentation of \$191.9 million for employment services to enable recipients to move off of aid and into sustainable employment. The 2006 Budget Act includes a TANF reserve of \$222.1 million in 2006-07, which is available for unanticipated needs in any program for which TANF Block Grant funds are appropriated, including CalWORKs benefits, employment services, county administration, and child care costs. The reserve includes \$40 million to fund incentive payments to counties in 2007-08 for improved program outcomes under the Pay for Performance program, and \$15 million to fund future program changes or improvements to CalWORKs to address increased work participation requirements under federal TANF reauthorization legislation.

## **Health Programs**

*Medi-Cal* – Medi-Cal, California’s Medicaid program, is a health care entitlement program for low-income individuals and families who receive public assistance or otherwise lack health care coverage. Medi-Cal serves just over one in six Californians. Federal law requires Medi-Cal to provide a set of basic services such as doctor visits, laboratory tests, x-rays, hospital inpatient and outpatient care, and skilled nursing care. Also, federal matching funds are available if states choose to provide any of numerous optional benefits. The federal government pays for half of the cost of providing most Medi-Cal services in California, including optional benefits. A wide range of public and private providers and facilities delivers these services. Providers are reimbursed by the traditional fee-for-service method or by payments from managed care plans. Approximately 3.3 million Medi-Cal beneficiaries (almost half of the people receiving Medi-Cal benefits and services) are currently enrolled in managed care plans.

Medi-Cal expenditures are estimated to be \$33.3 billion (\$12.8 billion from the General Fund), in 2005-06 and \$35.1 billion (\$13.8 billion General Fund) in 2006-07. The \$1.8 billion (\$946 million General Fund) increase in 2006-07 is due primarily to increases in caseload, utilization, and costs for services.

Average monthly caseload in Medi-Cal was estimated to be 6.6 million in 2005-06. Caseload is expected to increase in 2006-07 by approximately 85,200, or 1.29 percent, to 6.7 million eligible people. This overall increase compares to an expected 1.4 percent increase in the state's population over the same period.

The federal Medicare Modernization Act ("MMA") of 2003 established an outpatient prescription drug program, known as Medicare Part D, for approximately 43 million Medicare beneficiaries, including one million Californians eligible for both Medicare and Medi-Cal ("dual eligibles"). Effective January 1, 2006, the federal government no longer provides Medicaid matching funds to the states for drug categories now covered by Medicare. In addition, states no longer get Medicaid or supplemental rebates for drugs covered by Medicare. Although the intent of the MMA is for states to receive 10 percent of the savings for no longer providing drug coverage to dual eligibles, the revised federal formula for this calculation is projected to cost the state \$68.7 million in 2006-07 on an accrual accounting basis, rather than the \$169 million savings, which would reflect a full 10 percent. Due to federal implementation problems, the state is providing interim emergency drug coverage to dual eligibles who have not been able to receive their prescription drugs.

On February 8, 2006, President Bush signed the Deficit Reduction Act of 2005, which makes several changes to the federal Medicaid program that will impact Medi-Cal. The most significant fiscal change will require, beginning October 2009, states' managed care quality improvement fees to be assessed on all managed care plans, not just on those serving Medicaid beneficiaries. Without conforming statutory changes, the state would lose approximately \$250 million in annual federal revenues beginning in 2009-10 due to non-compliance because current California law permits the state to only collect managed care quality improvement fees on managed care plans serving Medi-Cal beneficiaries. In addition, the federal Deficit Reduction Act of 2005 requires, as a condition of receiving federal funds, that the Medi-Cal program verify the citizenship of those individuals who declare that they are citizens of the United States. Under this new provision, these individuals are required to show proof of identity and citizenship at the time of application and upon redetermination. This provision does not apply to or otherwise affect people who are applying for Medi-Cal as immigrants. The 2006 Health Trailer Bill (AB 1807) includes changes to California's statutory language to implement this change.

SSI/SSP – The federal Supplemental Security Income ("SSI") program provides a monthly cash benefit to eligible seniors and persons with disabilities who meet the program's income and resource requirements. In California, the SSI payment is augmented with a State Supplementary Payment ("SSP") grant. The 2006 Budget Act includes \$3.6 billion from the General Fund for the SSI/SSP Program. This represents a 4.1 percent increase from the revised 2005-06 funding level. The average monthly caseload in this program is estimated to be 1.2 million recipients in 2006-07, a 2.5 percent increase over the 2005-06 projected level.

The three-month delay of the January 2007 federal SSI cost-of-living-adjustment included in the 2005 Budget Act is rescinded in the 2006 Budget Act at a one-time cost of \$42.3 million. Effective January 1, 2007, the federal SSI payment will increase by an estimated 2.1 percent.

## Pension Trusts

The three principal retirement systems in which the state participates are the California Public Employees' Retirement System ("CalPERS"), the California State Teachers' Retirement System ("CalSTRS") and the University of California Retirement System ("UCRS"). The assets and liabilities of the funds administered by these systems, as well as certain other retirement funds administered by the state, are included in the financial statements of the state as fiduciary funds and described in Note 23 to the Audited Annual Financial Statements of the State of California for the year ended June 30, 2005 (the "Audited Financial Statements"), incorporated by reference in or attached to this APPENDIX A. See "FINANCIAL STATEMENTS."

### CalPERS

CalPERS administers the Public Employment Retirement Fund ("PERF"), which is a multiple employer defined benefit plan. In addition to the state, employer participants, as of June 30, 2005, included 1,059 school districts and 1,523 other public agencies. As of the same date, PERF had 1,016,982 active and inactive program members and 431,901 benefit recipients. The payroll for state employees covered by PERF for fiscal year 2004-05 was approximately \$12.9 billion.

Employees, except those participating in the non-contributory, second tier plan (and who receive generally lower benefits) contribute to PERF based upon required contribution rates. Approximately 6.5 percent of the employees participate in the second tier plan. As part of a memorandum of understanding with the employee unions, the state agreed to suspend employee contributions for miscellaneous and industrial employees for fiscal years 2002-03 and 2003-04. The impact on the unfunded liability from suspending the employee contribution for two years was \$354.5 million. These contributions will be repaid over the next thirty years through contributions toward the unfunded liability.

Contributions to PERF are determined annually on an actuarial basis. Payments into PERF are made from the employer contributions, including the state, and employee contributions. State contributions are made from the General Fund, Special Funds, and Non-Governmental Cost Funds. The following table shows the state's contributions to PERF for fiscal years 2001-02 through 2005-06 and its estimated contributions for fiscal year 2006-07. Approximately 55 percent of the state contributions to PERF are made from the General Fund.

**TABLE 8**

**State Contribution To PERF  
Fiscal Years 2001-02 to 2006-07**

<u>Fiscal Year</u>	<u>Amount</u>
2001-02	677,200,000
2002-03	1,190,000,000
2003-04	2,213,000,000
2004-05	2,564,000,000
2005-06	2,429,000,000
2006-07 <sup>(1)</sup>	2,665,000,000

<sup>(1)</sup> Estimated.

Source: State of California, Department of Finance.

Increasing contributions shown in Table 8 are due to several factors, including poor investment returns in the early 2000's and benefit enhancements enacted in 1999. See Table 9 below. The leveling off of contributions in 2005-06 and later years is due in part to new policies adopted by the CalPERS Board, described below.

Set forth below is a summary of additions and deductions from PERF for the past five fiscal years. These figures reflect activity for all employers, including the state.

**TABLE 9**

**Public Employees' Retirement Fund  
Schedule of Additions and Deductions  
(\$ in millions)\***

	Fiscal Year Ended June 30,				
	2001	2002	2003	2004	2005
Contributions: Employer	\$ 322	\$ 801	\$ 1,925	\$ 4,262	5,774
Contributions: Employee	1,766	2,155	1,888	2,266	3,177
Total Contributions	\$ 2,088	\$ 2,956	\$ 3,813	\$ 6,528	8,951
Net Investment Income/(Losses) (including Appreciation)	(12,256)	(9,704)	5,474	24,266	21,894
Total Additions	(10,160)	(6,744)	9,296	30,801	30,845
Total Deduction (Benefits Paid and Administrative Expenses)	(6,106)	(6,743)	(7,320)	(7,980)	(8,798)
Net Assets as of the Beginning of the Fiscal Year	172,541	156,274	142,787	144,763	167,584
Net Assets as of the End of the Fiscal Year	156,274	142,787	144,763	167,584	189,631
Change in Net Assets	(16,266)	(13,487)	1,975	22,821	22,047

\* Totals may not add up due to adjustments.

Source: State of California, Comprehensive Annual Financial Reports, Fiscal Year Ended June 30, 2001, 2002, 2003, 2004 and 2005.

Each employer (including the state) contributes an amount equal to the sum of the normal cost and amortization of the unfunded actuarial accrued liability, if any. Actuarial valuations of the PERF are performed as of June 30 of each year. The most recent valuation, as of June 30, 2005, showed an actuarial accrued unfunded liability allocable to state employees of \$14.8 billion. The actuarial valuation for PERF was based upon an assumed 7.75 percent investment return. The average net rate of return experienced by PERF over the past fifteen years, ten years and five years (in each case through fiscal year 2004-05) has been 9.6 percent, 9.3 percent, and 3.9 percent, respectively.

On April 19, 2005, the Board of Directors of CalPERS adopted a new policy for calculating the actuarial value of assets, spreading market value asset gains and losses over 15 years (rather than 3 years, as had been the practice) and changing the corridor limits for the actuarial value of assets from 90 percent–110 percent of market value to 80 percent–120 percent of market value. In addition, CalPERS will calculate the annual contribution amount with regard to gains and losses as a rolling 30 year amortization of all remaining unamortized gains or losses as opposed to the current 10 percent of such gains and losses. These changes are anticipated to reduce employer rate volatility by 50 percent.

Set forth below is a schedule of funding projections of the PERF with respect to the state's covered payroll. Actuarial information for each year is based upon an actuarial valuation performed as of the end of such fiscal year.

**TABLE 10**  
**Public Employees' Retirement Fund**  
**Schedule of Funding Projections (State only)**  
**(\$ in millions)**

	<b>Fiscal Year Ended June 30,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Actuarial Value of Assets	\$66,976	\$62,201	\$62,515	\$67,081	\$71,830
Actuarial Accrued Liabilities (AAL)-entry age	64,567	68,854	74,450	79,800	86,595
Excess of Actuarial Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL)	2,409	(6,653)	(11,935)	(12,719)	(14,765)
Covered Payroll	11,905	12,423	12,628	12,624	13,790
Funded Ratio	103.7%	90.3%	84.0%	84.1%	82.9%

Source: CalPERS State and Schools Actuarial Valuation, Fiscal Year Ended June 30, 2001, 2002, 2003, 2004 and 2005.

### CalSTRS

CalSTRS administers the Teacher's Retirement Fund, which is an employee benefit trust fund created to administer the State Teachers' Retirement Plan ("STRP"). STRP is a cost-sharing, multi-employer, defined benefit pension plan that provides retirement, disability and survivor benefits for teachers and certain other employees of the California public school system. The STRP is comprised of three programs: the Defined Benefit Program ("DB Program"), the Defined Benefit Supplement Program ("DBS"), and the Cash Balance Benefit Program. Within the DB Program there is also a Supplemental Benefits Maintenance Account ("SBMA") which provides purchasing power protection for retired members. As of June 30, 2005, the DB Program had approximately 1,200 contributing employers, approximately 574,676 active and inactive program members and 201,241 benefit recipients.

The state's General Fund contributions to the DB Program and the SBMA are established by statute. The contribution rate to the DB Program is currently 2.017 percent of teacher payroll for the fiscal year ending in the immediately preceding calendar year. This percentage resulted in a \$472 million contribution for fiscal year 2004-05. The contribution rate to the SBMA is currently 2.5 percent of teacher payroll for the fiscal year ending in the immediately preceding calendar year. This percentage resulted in a \$585 million contribution for fiscal year 2004-05. In 2004, CalSTRS actuaries determined that there was an unfunded liability associated with the 1990 benefit structure and, as a result, the state was required to pay an additional 0.524 percent (\$92 million from the General Fund) in fiscal year 2004-05 and one quarterly payment of \$31 million in fiscal year 2005-06 to the DB Program. The 2004 valuation of CalSTRS found the 1990 benefit structure to be fully funded and the state was not required to make this additional contribution in fiscal year 2005-06. In early 2006, an error in the calculation of teacher's salaries was discovered in CalSTRS' accounting system. As a result, it was determined that the unfunded liability associated with the 1990 benefit structure never existed. After discovering the accounting error, CalSTRS also determined that the state had overpaid the DB Program and the SBMA in fiscal year 2002-03 and underpaid these accounts in fiscal years 2003-04 through 2005-06, resulting in a

net underpayment of \$3.1 million. Overall, the accounting error resulted in the state making excess contributions to CalSTRS in the amount of \$119.5 million. For the 2006 Budget Act, this amount is to be recognized as a prepayment of the amounts owing from the state to the Teachers' Retirement Fund in 2006-07, which will correspondingly reduce the remaining amount to be transferred in 2006-07 from the General Fund. Finally, an actuarial analysis performed in 2005 at the direction of the Department of Finance concluded that the currently required state contributions to the SBMA are more than sufficient to maintain purchasing power at 80 percent. The following table shows the state's contributions to CalSTRS for fiscal years 2001-02 through 2005-06 and its estimated contributions for fiscal year 2006-07.

**TABLE 11**

**State Contribution To CalSTRS  
Fiscal Years 2001-02 to 2006-07**

	<b>DB Program</b>	<b>SBMA</b>
2001-02	\$384,749,000	\$487,025,000
2002-03	430,538,000	544,984,000
2003-04	450,895,000	58,868,000
2004-05	563,867,000	584,925,000
2005-06	499,697,000	581,367,000
2006-07 <sup>(1)</sup>	360,182,000	598,391,000

<sup>(1)</sup> Estimated.

Source: State of California, Department of Finance.

The table above does not reflect the impact of the Superior Court decision requiring the state to pay \$500 million of the contribution deferred in fiscal year 2003-04, to CalSTRS. See "LITIGATION—Challenge Seeking Payment to Teachers' Retirement Board."

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Set forth below is a summary of additions and deductions from the DB Program for the past five fiscal years. These figures reflect activity for all employers, as well as the state's contribution.

**TABLE 12**

**State Teachers' Retirement Defined Benefit Program Fund  
Schedule of Additions and Deductions  
(\$ in millions)\***

	<b>Fiscal Year Ended June 30,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Contributions: Employer	\$ 1,884	\$ 1,725	\$ 1,968	\$ 2,047	\$ 2,105
Contributions: Employee	1,843	1,873	2,094	2,210	2,327
Contributions: State <sup>(1)</sup>	946	916	1,015	549	1,219
Total Contributions	\$ 4,674	\$ 4,514	\$ 5,077	\$ 4,806	\$ 5,650
Net Investment Income/(Losses) (including Appreciation)	(10,232)	(6,297)	3,688	16,607	14,138
Total Additions	(5,558)	(1,789)	8,765	21,412	19,779
Total Deduction (Benefits Paid and Administrative Expenses)	(4,086)	(4,639)	(5,102)	(5,723)	(6,317)
Net Assets as of the Beginning of the Fiscal Year	112,782	103,138	96,709	100,372	116,061
Net Assets as of the End of the Fiscal Year	103,138	96,709	100,372	116,061	129,524
Change in Net Assets	(9,644)	(6,428)	3,663	15,689	13,462

\* Totals may not add up due to adjustments.

<sup>(1)</sup> Includes federal funds.

Source: State of California, Comprehensive Annual Financial Reports, Fiscal Year Ended June 30, 2001, 2002, 2003, 2004 and 2005. California State Teachers Retirement System, Comprehensive Annual Financial Reports, Fiscal Year Ended June 30, 2001, 2002, 2003, 2004 and 2005.

Each employer contributes 8.25 percent of payroll, while employees contribute 6 percent of pay. The most recent actuarial valuation, performed as of June 30, 2005 showed an actuarial accrued unfunded liability of \$20.3 billion. The significant reduction in the unfunded liability of almost \$3 billion since last year was largely due to the discovery of the error in CalSTRS' accounting system. The actuarial valuation of the DB Program is based upon an assumed 8 percent investment return. The average net rate of return experienced by the DB Program over the past fifteen years, ten years and five years (in each case through fiscal year 2005-06) was 10.4 percent, 9.5 percent and 7.9 percent, respectively.

Set forth below is a schedule for funding projections for the DB Program for the past five fiscal years. Actuarial information is based upon actuarial valuations performed as of the end of such fiscal year, except information as of June 30, 2002 is based upon actuarial valuation for June 30, 2001.

**TABLE 13**

**State Teachers' Retirement Defined Benefit Program Fund  
Schedule of Funding Projections  
(\$ in millions)**

	<b>Fiscal Year Ended June 30,</b>				
	<b>2001</b>	<b>2002<sup>(1)</sup></b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Actuarial Value of Assets	\$107,654	\$107,654	\$108,667	\$114,094	\$121,882
Actuarial Accrued Liabilities (AAL)-entry age	109,881	109,881	131,777	138,254	142,193
Excess of Actuarial Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL)	(2,227)	(2,227)	(23,110)	(24,160)	(20,311)
Covered Payroll	20,585	20,585	23,867	23,764	23,293
Funded Ratio	98.0%	98.0%	82.5%	82.5%	85.7%

<sup>(1)</sup> Based upon actuarial valuation as of June 30, 2001.

Source: CalSTRS Defined Benefit Program Actuarial Valuation as of June 30, 2001, 2002, 2003, 2004, and 2005.

**UC Regents**

The University of California Retirement System consists of: (i) a retirement plan, which is a single employer defined benefit plan funded with university and employee contributions ("UCRP"); (ii) a voluntary early retirement incentive program, which is a defined benefit plan for employees who take early retirement ("PERS-VERIP"); and (iii) three defined contribution plans. As of June 30, 2005, plan membership totaled 215,016, comprised of 124,642 active members, 47,123 inactive members (includes terminated nonvested employees who are eligible for a refund), and 43,251 retirees and beneficiaries receiving benefits.

The state does not make any contributions to the University of California Retirement System. As of June 30, 2005, employee and employer contributions were not required to UCRP and PERS-VERIP, due to the fully funded status of each plan.

Set forth below is a summary of additions and deductions from the UC Regents Retirement Fund for the past five fiscal years.

**TABLE 14**

**University of California Retirement Plan Fund**  
**Schedule of Additions and Deductions**  
(\$ in thousands)\*

	<b>Fiscal Year Ended June 30,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Contributions: Employer	\$ 517	\$ 118	\$ 811	\$ 5,150	\$737
Contributions: Employee	4,405	2,954	7,060	2,503	1,653
Total Contributions	\$ 4,922	\$ 3,072	\$ 7,871	\$ 7,653	\$2,390
Net Investment Income/(Losses) (including Appreciation)	(2,301,959)	(3,460,714)	1,892,384	4,998,664	3,982,916
Total Additions	(2,297,037)	(3,457,642)	1,900,255	5,006,317	3,985,306
Total Deduction (Benefits Paid and Administrative Expenses)	(903,981)	(970,453)	(1,015,248)	(1,145,469)	(1,315,466)
Net Assets as of the Beginning of the Fiscal Year	42,070,918	38,869,900	34,441,805	35,326,812	39,187,660
Net Assets as of the End of the Fiscal Year	38,869,900	34,441,805	35,326,812	39,187,660	41,857,500
Change in Net Assets	(3,201,018)	(4,428,095)	885,007	3,860,848	2,669,840

\* Totals may not add up due to adjustments

Source: State of California, Comprehensive Annual Financial Reports, Fiscal Year Ended June 30, 2001, 2002, 2003, 2004 and 2005.

Set forth below is a schedule for funding projections for the UCRP for the past five fiscal years. Actuarial information is based upon valuation performed as of the end of the fiscal year.

**TABLE 15**

**University of California Retirement Plan Fund**  
**Schedule of Funding Projections**  
(\$ in millions)

	<b>Fiscal Year Ended June 30,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Actuarial Value of Assets	\$40,554	\$41,649	\$41,429	\$41,293	\$41,085
Actuarial Accrued Liabilities (AAL)-entry age	27,451	30,100	32,955	35,034	37,252
Excess of Actuarial Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL)	13,103	11,549	8,474	6,259	3,833
Covered Payroll	6,539	7,227	7,734	7,835	8,150
Funded Ratio	147.7%	138.4%	125.7%	117.9%	110.3%

Source: University of California Retirement Plan Actuarial Valuation Report as of July 1, 2001, 2002, 2003, 2004 and 2005.

### Post Retirement Benefits

The state also provides post-employment health care and dental benefits to its employees and their spouses and dependents, when applicable, and recognizes these costs on a “pay-as-you-go” basis. Table 16 shows the state’s General Fund budget for post-employment benefits from fiscal years 2002-03 to 2006-07 and does not reflect any future liability for current employees or annuitants. It is anticipated that these costs will continue to grow in the future. As of June 30, 2005, approximately 124,695 retirees were enrolled to receive health benefits and 101,655 to receive dental benefits. The employer contribution for health premiums maintains the average 100/90 percent contribution formula established in the Government Code. Under this formula, the state averages the premiums of the four largest health benefit plans in order to calculate the maximum amount the state will contribute toward the retiree’s health benefits. The state also contributes 90 percent of this average for the health benefits of each of the retiree’s dependents. Employees vest for this benefit after serving ten years with the state. With ten years of service credit, employees are entitled to 50 percent of the state’s full contribution. This rate increases by 5 percent per year and with 20 years of service, the employee is entitled to the full 100/90 formula.

**TABLE 16**

**General Fund Budget for Post-Employment Benefits  
Fiscal Years 2002-03 through 2006-07**

<u>Fiscal Year</u>	<u>Amount</u>
2002-03	\$ 576,620,000
2003-04	660,772,000
2004-05	795,554,000
2005-06	895,197,000
2006-07	1,019,368,000

Source: Budget Acts of 2002-03, 2003-04, 2004-05, 2005-06 and 2006-07

On June 21, 2004, the Governmental Accounting Standard Board released its Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (“Statement No. 45”). Statement No. 45 establishes standards for the measurement, recognition and display of post-employment healthcare as well as other forms of post-employment benefits, such as life insurance, when provided separately from pension plan expenditures and related liabilities in the financial reports of state and local governments. Under Statement No. 45, governments will be required to: (i) measure the cost of benefits, and recognize other post-employment benefits expense, on the accrual basis of accounting in periods that approximate employees’ years of service; (ii) provide information about the actuarial liabilities for promised benefits associated with past services and whether, or to what extent, the future costs of those benefits have been funded; and provide information useful in assessing potential demands on the employer’s future cash flows. Statement 45 reporting requirements are effective for the state in the fiscal year beginning July 1, 2007. The state plans to include the actuarial computation of its liability for post-employment health care benefits in the 2007-08 financial statements.

The 2006 Budget Act included funding which will allow the State Controller’s Office to contract with a private actuarial firm to calculate the state’s liability for these benefits. Such report, when made, may negatively affect the state’s financial reports and impact its credit ratings if the state does not adequately manage the long-term costs for other post employment benefits. In February of 2006, the Legislative Analyst’s Office released a report suggesting that the unfunded liability for these benefits could be tens of billions of dollars, and that the cost to fully amortize the unfunded liability could be several billion dollars annually. The costs suggested by the Legislative Analyst’s Office are not based on

any actuarial projections reflecting data for California, and may or may not be consistent with the results of the proposed actuarial valuation.

## **THE BUDGET PROCESS**

### **General**

The state's fiscal year begins on July 1 and ends on June 30 of the following year. The state's General Fund Budget operates on a legal basis, generally using a modified accrual system of accounting for its General Fund, with revenues credited in the period in which they are measurable and available and expenditures debited in the period in which the corresponding liabilities are incurred.

The annual budget is proposed by the Governor by January 10 of each year for the next fiscal year (the "Governor's Budget"). Under state law, the annual proposed Governor's Budget cannot provide for projected expenditures in excess of projected revenues for the ensuing fiscal year. Following the submission of the Governor's Budget, the Legislature takes up the proposal. As required by the Balanced Budget Amendment ("Proposition 58") and as described below, beginning with fiscal year 2004–05, the Legislature may not pass a budget bill in which General Fund expenditures exceed estimated General Fund revenues and fund balances at the time of the passage and as set forth in the budget bill.

Under the State Constitution, money may be drawn from the Treasury only through an appropriation made by law. The primary source of annual expenditure appropriations is the annual Budget Act as approved by the Legislature and signed by the Governor. The Budget Act must be approved by a two-thirds majority vote of each House of the Legislature. See "THE BUDGET PROCESS—Constraints on the Budget Process" below. The Governor may reduce or eliminate specific line items in the Budget Act or any other appropriations bill without vetoing the entire bill. Such individual line-item vetoes are subject to override by a two-thirds majority vote of each House of the Legislature.

Appropriations also may be included in legislation other than the Budget Act. Except as noted in the previous paragraph and in the next sentence, bills containing General Fund appropriations must be approved by a two-thirds majority vote in each House of the Legislature and be signed by the Governor. Bills containing appropriations for K-12 schools or community colleges ("K-14 education") only require a simple majority vote. Continuing appropriations, available without regard to fiscal year, may also be provided by statute or the State Constitution.

Funds necessary to meet an appropriation are not required to be in the State Treasury at the time an appropriation is enacted; revenues may be appropriated in anticipation of their receipt.

### **Constraints on the Budget Process**

Over the years, a number of laws and constitutional amendments have been enacted, often through voter initiatives, which have increased the difficulty of raising state taxes, restricted the use of the state's General Fund or special fund revenues, or otherwise limited the Legislature and the Governor's discretion in enacting budgets. Historic examples of provisions that make it more difficult to raise taxes include Proposition 13, passed in 1978, which, among other things, required that any change in state taxes enacted for the purpose of increasing revenues collected pursuant thereto, whether by increased rates or changes in computation, be approved by a two-thirds vote in each house of the Legislature. Examples of provisions restricting the use of General Fund revenues are Proposition 98, passed in 1988, which mandates that a minimum amount of General Fund revenues be spent on local education, and Proposition 10, passed in 1988, which raised taxes on tobacco products and mandated how the additional

revenues would be expended. See “STATE FINANCES—Proposition 98” and “—Sources of Tax Revenue—Taxes on Tobacco Products.”

More recently, a new series of Constitutional amendments sponsored by Governor Schwarzenegger and approved by the voters, have also affected the budget process. These include Proposition 58, approved in 2004, which requires the adoption of a balanced budget and restricts future borrowing to cover budget deficits, Proposition 1A, approved in 2004, which limits the Legislature’s power over local revenue sources, and Proposition 1A approved at the November 7, 2006 election, which limits the Legislature’s ability to use sales taxes on motor vehicle fuels for any purpose other than transportation. These recent constitutional amendments are described below.

#### *Balanced Budget Amendment (Proposition 58)*

Proposition 58, approved by the voters in 2004, requires the state to enact a balanced budget, and establish a special reserve in the General Fund and restricts future borrowing to cover fiscal year end deficits. As a result of the provisions requiring the enactment of a balanced budget and restricting borrowing, the state would in some cases have to take more immediate actions to correct budgetary shortfalls. Beginning with the budget for fiscal year 2004–05, Proposition 58 requires the Legislature to pass a balanced budget and provides for mid-year adjustments in the event that the budget falls out of balance and the Governor calls a special legislative session to address the shortfall. The balanced budget determination is made by subtracting expenditures from all available resources, including prior-year balances.

If the Governor determines that the state is facing substantial revenue shortfalls or spending increases, the Governor is authorized to declare a fiscal emergency. He or she would then be required to propose legislation to address the emergency, and call the Legislature into special session for that purpose. If the Legislature fails to pass and send to the Governor legislation to address the fiscal emergency within 45 days, the Legislature would be prohibited from: (i) acting on any other bills or (ii) adjourning in joint recess until such legislation is passed.

Proposition 58 also requires that a special reserve (the “Budget Stabilization Account” or “BSA”) be established in the state’s General Fund. Beginning with fiscal year 2006–07, a specified portion of estimated annual General Fund revenues would be transferred by the State Controller into the Budget Stabilization Account no later than September 30 of each fiscal year. These transfers would continue until the balance in the Budget Stabilization Account reaches \$8 billion or 5 percent of the estimated General Fund revenues for that fiscal year, whichever is greater. The annual transfer requirement would be in effect whenever the balance falls below the \$8 billion or 5 percent target. The annual transfers can be suspended or reduced for a fiscal year by an executive order issued by the Governor no later than June 1 of the preceding fiscal year. Proposition 58 also provides that one-half of the annual transfers shall be used to retire Economic Recovery Bonds, until a total of \$5 billion has been used for that purpose. The 2006 Budget Act transfers \$944 million to the Budget Stabilization Account, of which \$472 million will be used to retire Economic Recovery Bonds. See “CURRENT STATE BUDGET – 2006 Budget Act.”

Proposition 58 also prohibits certain future borrowing to cover fiscal year end deficits. This restriction applies to general obligation bonds, revenue bonds, and certain other forms of long-term borrowing. The restriction does not apply to certain other types of borrowing, such as: (i) short-term borrowing to cover cash shortfalls in the General Fund (including revenue anticipation notes or revenue anticipation warrants currently used by the state), or (ii) inter-fund borrowings.

### Local Government Finance (Proposition 1A of 2004)

As described under “STATE FINANCES—Local Governments” above, Senate Constitutional Amendment No. 4 (also known as “Proposition 1A”), approved by the voters in the November 2004 election, amended the State Constitution to, among other things, reduce the Legislature’s authority over local government revenue sources by placing restrictions on the state’s access to local governments’ property, sales, and vehicle license fee revenues as of November 3, 2004. Beginning with fiscal year 2008–09, the state will be able to borrow up to 8 percent of local property tax revenues, but only if the Governor proclaims such action is necessary due to a severe state fiscal hardship and two-thirds of both houses of the Legislature approve the borrowing. The amount borrowed is required to be paid back within three years. The state also will not be able to borrow from local property tax revenues for more than 2 fiscal years within a period of 10 fiscal years. In addition, the state cannot reduce the local sales tax rate or restrict the authority of local governments to impose or change the distribution of the statewide local sales tax.

Proposition 1A also prohibits the state from mandating activities on cities, counties or special districts without providing for the funding needed to comply with the mandates. Beginning in fiscal year 2005–06, if the state does not provide funding for the mandated activity, the requirement on cities, counties or special districts to abide by the mandate would be suspended. In addition, Proposition 1A expanded the definition of what constitutes a mandate on local governments to encompass state action that transfers to cities, counties and special districts financial responsibility for a required program for which the state previously had partial or complete responsibility. The state mandate provisions of Proposition 1A do not apply to schools or community colleges nor to mandates relating to employee rights.

Proposition 1A further requires the state to reimburse cities, counties, and special districts for mandated costs incurred prior to the 2004-05 fiscal year over a term of years. Chapter 72, Statutes of 2005 (AB 138) requires the payment of mandated costs incurred prior to 2004-05 to begin in 2006-07 and to be paid over a term of 15 years. Currently the estimated cost for claims for mandated costs incurred prior to the 2004-05 fiscal year is \$1.199 billion. The 2006 Budget Act contains \$169.9 million for reimbursement of mandated local government costs incurred prior to 2004-05.

### After School Education Funding (Proposition 49)

An initiative statute, Proposition 49, called the “After School Education and Safety Program of 2002,” was approved by the voters on November 5, 2002, and requires the state to expand funding for before and after school programs in the state’s public (including charter) elementary, middle and junior high schools. This increase is required in 2006-07, and the 2006 Budget Act includes a \$428.4 million increase for these programs, for a total of \$550 million. The 2006 Budget Act allocates \$547.4 million for grants for before and after school programs, and \$2.6 million for administrative costs for the California State Department of Education. The additional funds are added to the Proposition 98 minimum funding guarantee for K-14 education and, in accordance with the initiative, cannot be reduced in future years unless the Proposition 98 guarantee is suspended. See “STATE FINANCES—Proposition 98”.

### Mental Health Services (Proposition 63)

On November 2, 2004 the voters approved Proposition 63, which imposes a 1 percent tax surcharge on taxpayers with annual taxable income of more than \$1 million for purposes of funding and expanding mental health services. In addition, Proposition 63 prohibits the Legislature or the Governor

from redirecting funds now used for mental health services to other purposes or from reducing General Fund support for mental health services below the levels provided in fiscal year 2003–04.

*Transportation Financing (Proposition 1A, November 2006 Ballot)*

On November 7, 2006 voters approved Proposition 1A, which had been placed on the ballot by the Legislature as Senate Constitutional Amendment No. 7, to protect Proposition 42 transportation funds from any further suspensions. Current provisions of the State Constitution enacted as Proposition 42 in 2002, permit the suspension of the annual transfer of motor vehicle fuel sales tax revenues from the General Fund to the Transportation Investment Fund if the Governor declares that the transfer will result in a “significant negative fiscal impact” on the General Fund and the Legislature agrees with a two-thirds vote of each house. The new measure modifies the constitutional provisions of Proposition 42 in a manner similar to Proposition 1A of 2004, so that if such a suspension occurs, the amount owed by the General Fund must be repaid to the Transportation Investment Fund within three years, and only two such suspensions can be made within any ten-year period. In 2003-04, \$868 million of the scheduled Proposition 42 transfer was suspended, and in 2004-05 the full transfer of \$1.258 billion was suspended. The Proposition 42 transfer was fully funded in 2005-06 at \$1.355 billion. The 2006 Budget Act fully funds the Proposition 42 transfer at \$1.420 billion for 2006-07, and also includes \$1.415 billion (\$1.215 billion General Fund) for advance repayment of a portion of the 2003-04 and 2004-05 suspensions. See “CURRENT STATE BUDGET - 2006 Budget Act”.

## **PRIOR FISCAL YEARS’ BUDGETS**

### **Fiscal Years Prior to 2004-05**

The California economy grew strongly between 1994 and 2000, generally outpacing the nation, and as a result, for the five fiscal years from 1995–96 to 1999–00, the General Fund tax revenues exceeded the estimates made at the time the budgets were enacted. These additional funds were largely directed to school spending as mandated by Proposition 98, to make up shortfalls from reduced federal health and welfare aid and to fund new ongoing program initiatives, including education spending above Proposition 98 minimums, tax reductions, aid to local governments and infrastructure expenditures. The state ended the 2000–2001 fiscal year with a budget reserve of \$5.39 billion.

However, during fiscal year 2001–02, the state experienced an unprecedented drop in revenues compared to the prior year. The three largest tax sources generated only \$59.7 billion, a drop of over \$13 billion from fiscal year 2000–01, the vast bulk of which was attributable to reduced personal income taxes from stock option and capital gains activity. During the three fiscal years between 2001-02 and 2003-04, the state encountered severe budgetary difficulties because of reduced revenues and failure to make equivalent reductions in expenditures, resulting in successive budget deficits. The budgets for these years included substantial reliance on one-time measures, internal borrowing, and external borrowing. The state also faced a cash flow crisis during this period which was relieved by the issuance of Revenue Anticipation Warrants in June 2002 and June 2003 and Economic Recovery Bonds in the spring of 2004. Additional information about prior fiscal years’ budgets for this period can be obtained from prior official statements of state bonds.

### **2004 Budget Act**

The 2004 Budget Act was adopted by the Legislature on July 29, 2004, along with a number of implementing measures, and signed by the Governor on July 31, 2004. This was the first budget signed by Governor Schwarzenegger following his election to office after a recall of Governor Davis in November 2003. The 2004 Budget Act largely reflected the proposals contained in the May Revision of



the 2004-05 Governor's Budget, including the application for budgetary purposes of \$2 billion of proceeds of the economic recovery bonds issued in fiscal year 2003-04 (see "STATE INDEBTEDNESS AND OTHER OBLIGATIONS—Economic Recovery Bonds").

Under the 2004 Budget Act, General Fund revenues were projected to increase 3.6 percent, from \$74.6 billion in fiscal year 2003-04 (which included approximately \$2.3 billion in additional tobacco securitization bond proceeds) to \$77.3 billion in fiscal year 2004-05. The revenue projections assumed a continuing rebound in California's economy as reflected in several key indicators. Excluding the impact of the economic recovery bonds, General Fund expenditures were estimated to increase by 6.7 percent, from \$75.6 billion in fiscal year 2003-04 to \$80.7 billion in fiscal year 2004-05. The June 30, 2005 reserve was projected to be \$768 million, compared to an estimated June 30, 2004 reserve of \$2.198 billion. Final results for the fiscal year were substantially better than these initial projections; see "Fiscal Year 2004-05 Revised Estimates" below.

In summary, the 2004 Budget Act addressed a projected \$13.9 billion budget shortfall through expenditure cuts (\$4.0 billion or 28.7 percent), cost avoidance (\$4.4 billion or 31.7 percent), fund shifts (\$1.6 billion or 11.2 percent), loans or borrowing (\$2.1 billion or 15.4 percent), and transfers and other revenue (\$1.8 billion or 13.0 percent).

The 2004 Budget Act contained the following major components:

1. Rebasing Proposition 98 Minimum Funding Guarantee—The level of Proposition 98 appropriations was reset at a level approximately \$2 billion less than would otherwise be required for fiscal year 2004-05 pursuant to legislation relating to the 2004 Budget Act. See "STATE FINANCES—Proposition 98." (When revenues for 2004-05 were substantially higher than projected, and the Administration did not revise Proposition 98 expenditures, litigation was filed challenging this action. This litigation was settled as part of the 2006 Budget Act. See "CURRENT STATE BUDGET" below.)

2. Higher Education—A new fee policy for higher education was implemented. In fiscal year 2004-05, fees were increased 14 percent for undergraduates and 20 percent for graduate students (25 percent for CSU graduate students majoring in non-teacher preparation programs). The 2004 Budget Act included \$750 million in various spending reductions for higher education from otherwise mandated levels.

3. Health and Human Services—The 2004 Budget Act included \$992 million in reductions in various social service programs from otherwise mandated levels. Based on updated projections of caseload and cost-per-case, these savings are now estimated to be \$1 billion in fiscal year 2004-05.

4. Pension Reform—The 2004 Budget Act eliminated state contributions to CalPERS on behalf of new state employees for the first two years of employment. In addition, the 2004 Budget Act assumed the issuance of \$929 million pension obligation bonds to cover a portion of the state's required contributions to CalPERS in fiscal year 2004-05. The pension bonds were not issued in fiscal year 2004-05 due to litigation delays. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS—Pension Obligation Bonds."

5. Tax Relief—The 2004 Budget Act reflected the elimination of the VLF offset program beginning in fiscal year 2004-05. See "STATE FINANCES—Local Governments."

6. Other Revenue Enhancements and Expenditure Reductions—The 2004 Budget Act also included \$1.258 billion in savings from the suspension of the Transportation Investment Fund (Proposition 42) transfer.

Fiscal Year 2004–05 Revised Estimates. Final estimates relating to the 2004-05 fiscal year, as released in the 2006-07 Governor’s Budget in January, 2006, show that the state experienced substantially more favorable results than were projected at the time the 2004 Budget Act was signed. As a result of revised estimates for years prior to 2004-05, tax amnesty payments (see below) and improved economic results which generated major increases in tax revenues, the Administration estimates that total prior year resources, plus revenues and transfers for 2004-05, were about \$91.5 billion, more than \$9.1 billion higher than originally estimated. Expenditures increased by about \$1.1 billion. As a result, the fund balance at June 30, 2005 was estimated at about \$9.6 billion, of which \$9.1 billion was in the SFEU, compared to the original 2004 Budget Act estimate of \$768 million in the SFEU.

Tax Amnesty Program - Chapter 226, Statutes of 2004, created a personal income tax, corporate tax, and sales and use tax amnesty program for 2002 and prior years. Penalties were waived for taxpayers who applied for the amnesty during the amnesty period of February 1, 2005 to March 31, 2005. The effect of amnesty on the accounting for General Fund revenues has been distortive since payments for years before the current year are accounted for as a “prior year adjustment” for the current year rather than being carried back to those earlier years. Additionally, since some payments were made in advance of future year payments the revenue estimates in the current year, the budget year, and beyond will be lower even though the payments received are accounted for as “prior year adjustments” to the current year. Moreover, much of the money that came in during the amnesty period was in the form of “protective payments,” amounts submitted to avoid the extra penalty, but that would have otherwise been submitted in future years, or that will prove not to have been due at all, as some taxpayers will win their disputes. These refunds must be accounted for in future years.

For budgetary purposes, revenues from the amnesty program resulted in a carry-over adjustment increasing the beginning General Fund balance for fiscal year 2004-05 by \$3.8 billion. This carry over adjustment was and will be reduced in fiscal year 2004-05 and subsequent fiscal years to account for refunds and the recognition of income over a period of time. The estimates of these adjustments has varied as more up-to-date information has been received, as reflected in differing estimates shown in the footnotes to Figure 1 on page A-45, and Figure 2 on page A-48. The 2005 Budget Act estimated a net multi-year General Fund revenue gain from the amnesty program at \$380 million, which represented a \$180 million increase from the \$200 million gain assumed at the time of the 2005-06 Governor’s Budget. These amounts constituted one-time revenues that the 2005 Budget Act used for one-time purposes.

## **2005 Budget Act**

The 2005 Budget Act was adopted by the Legislature on July 7, 2005, along with a number of implementing measures, and signed by the Governor on July 11, 2005. In approving the budget, the Governor vetoed \$190 million in appropriations (including \$115 million in General Fund appropriations).

Under the 2005 Budget Act, General Fund revenues and transfers were projected to increase 5.7 percent, from \$79.9 billion in fiscal year 2004-05 to \$84.5 billion in fiscal year 2005-06. The revenue projections assumed continued but moderating growth in California’s economy as reflected in several key indicators. The 2005 Budget Act contained General Fund appropriations of \$90.0 billion, compared to \$81.7 billion in 2004-05. The difference between revenues and expenditures in fiscal year 2005-06 was funded by using a part of the \$7.5 billion fund balance at June 30, 2005. The June 30, 2006 reserve was projected to be \$1.302 billion, compared to an estimated June 30, 2005 reserve of \$6.857 billion. About \$900 million of this reserve was to be set aside for payment in fiscal year 2006-07 of tax refunds and other adjustments related to the tax amnesty program implemented in early 2005. See “ – 2004 Budget Act – Fiscal Year 2004-05 Revised Estimates.”

The 2005 Budget Act also included special fund expenditures of \$23.3 billion and bond fund expenditures of \$4.0 billion. The state issued \$3.0 billion of Revenue Anticipation Notes (RANs) to meet the state's short-term cash flow needs for fiscal year 2005-06.

The 2005 Budget Act contained the following major components:

1. Proposition 98 – General Fund expenditures increased by \$2.582 billion, or 7.6 percent, to \$36.6 billion. This reflected increases in the Proposition 98 guaranteed funding level resulting from increases in General Fund revenues in fiscal year 2005-06, adjusted for changes in local revenues. The 2005 Budget Act fully funded enrollment growth and a 4.23 percent cost of living increase. Per pupil spending under Proposition 98 was projected to be \$7,402, compared to \$7,023 in the previous year. The 2005 Budget Act reflected savings of \$3.8 billion in 2004-05, which would be restored to the Proposition 98 budget in future years as General Fund revenue growth exceeds personal income growth. See “STATE FINANCES—Proposition 98.”

2. Higher Education – The 2005 Budget Act marked the first year of funding for the Higher Education Compact under this Administration. The Compact was signed in spring 2004 with both UC and CSU to provide funding stability for enrollment growth and basic support over the next six fiscal years. The 2005 Budget Act provided for total Higher Education funding of \$17.8 billion from all revenue sources, including \$10.2 billion General Fund. General Fund support for both the UC and CSU was increased by \$134 million (about 5 percent) compared to 2004-05. The 2005 Budget Act assumed fee increases for undergraduate and graduate students, consistent with the Compact, which were approved by the UC and CSU governing boards.

3. Health and Human Services – The 2005 Budget Act increased General Fund expenditures by \$2.1 billion, or 8.5 percent, to \$27.1 billion for Health and Human Services programs. This increase consisted of higher Medi-Cal expenditures of \$1.3 billion, Department of Developmental Services expenditures of \$152 million, Department of Mental Health expenditures of \$306 million, and Department of Social Services expenditures of \$55 million, among other things. The 2005 Budget Act reflected the suspension of the July 2005 and July 2006 CalWORKs grant cost-of-living-adjustments (COLAs), yielding General Fund savings of \$136 million in 2005-06 and \$139 million in 2006-07. The 2005 Budget Act further assumed the January 2006 and January 2007 COLAs for SSI/SSP recipients would be suspended for estimated General Fund savings of \$132 million in 2005-06, \$407.5 million in 2006-07, and \$281 million in 2007-08. The 2005 Budget Act also included federal fiscal relief of \$223 million due to progress in implementing a single, statewide automated child support system.

4. Retirement and Employee Compensation – The 2005 Budget Act provided for full funding of the state's statutory obligations to the State Teachers' Retirement System (“CalSTRS”). The 2005 Budget Act also reflected an augmentation of \$355 million for salary increases and dental and vision premium increases for certain bargaining units.

5. Vehicle License Fee Gap Loan Repayment – The 2005 Budget Act fully repaid the \$1.2 billion that local governments lost between July and October of 2003, when the Vehicle License Fee offset program was temporarily suspended. The state was not required to repay the gap loan until August of 2006. This payment was made in August 2005.

6. Transportation Funding – The Proposition 42 transfer was fully funded at an estimated \$1.3 billion.

7. Financial Instruments – The 2005 Budget Act reflected the state's issuance of pension obligation bonds to fund approximately \$525 million of the state's 2005-06 retirement obligation to the

California Public Employees' Retirement System, but an adverse court ruling prevented issuance of these bonds. See "LITIGATION – Matter Seeking Validation of Pension Obligation Bonds." The 2005 Budget Act reflected the results of the refinancing of the Golden State Tobacco Securitization Bonds, Series 2003B. In exchange for its continued backing of these bonds, the General Fund received \$525 million in August 2005. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Pension Obligation Bonds" and "– Tobacco Settlement Revenue Bonds."

The original 2005-06 Governor's Budget had included a proposal to issue \$464 million of judgment bonds to finance the pending settlement of the *Paterno* lawsuit (dealing with the state's liability for past flood damages), but subsequent developments led to the removal of this proposal from the budget. The state settled three related lawsuits through stipulated judgments. The largest settlement, in the amount of \$428 million, provided for the state to make annual payments of \$42.8 million per year, plus interest, for ten years; the payments are subject to annual appropriation by the Legislature. The first year's payment, as well as \$36 million to fully discharge the other two stipulated judgments, was included in the 2005 Budget Act.

8. Taxes – The 2005 Budget Act contained no new taxes.

#### **Fiscal Year 2005-06 revised estimates as of the 2006 Budget Act**

The 2006-07 May Revision projected that the state would end fiscal year 2005-06 with a budgetary reserve of \$8.8 billion, up \$7.5 billion from estimates made at the time of the 2005 Budget Act. The 2006 Budget Act projects that the state will have a budgetary reserve at June 30, 2006 of \$9.0 billion, up \$7.7 billion from the 2005 Budget Act estimate. This change in budgetary reserve is a result of revenue and expenditure changes outlined below, and an increase of \$2.3 billion in revenues attributed to 2004-05. See "PRIOR FISCAL YEARS' BUDGETS – 2004 Budget Act". As of the adoption of the 2006 Budget Act, General Fund revenues and transfers for 2005-06 are projected at \$92.7 billion, an increase of \$8.2 billion compared with 2005 Budget Act estimates. This includes the following significant adjustments since the 2005 Budget Act:

- \$8.196 billion increase in major tax revenues due to the improved economic forecast;
- \$245 million increase due to higher State Lands Royalties and Unclaimed Property revenues;
- \$252 million loss in revenues due to not issuing pension obligation bonds as a result of pending litigation contesting their issuance.

As of the adoption of the 2006 Budget Act, General Fund expenditures for fiscal year 2005-06 are projected at \$92.7 billion, an increase of \$2.7 billion compared with 2005 Budget Act estimates. This includes the following significant changes since the 2005 Budget Act:

- \$1.829 billion increase in Proposition 98 expenditures;
- \$500 million for levee evaluation and flood control system improvements;
- \$273 million loss of expenditure savings due to not issuing pension obligation bonds as a result of pending litigation contesting their issuance;
- \$137 million in additional expenditures for employee compensation;
- \$153 million decrease in the Medi-Cal program.

Set forth below is a chart showing a General Fund Budget Summary for fiscal year 2005–06 as originally projected by the 2005 Budget Act, as subsequently revised by the 2006-07 Governor’s Budget, and as further revised by the 2006 Budget Act.

Budget Summary for Fiscal Year 2005-06

**FIGURE 1**

**2005–06 General Fund Budget Summary  
(\$ Millions)**

	<b>As of 2005 Budget Act</b>	<b>As of 2006–07 Governor’s Budget</b>	<b>As of 2006 Budget Act</b>
<b>Prior Year Resources Available</b>	\$7,498 <sup>(1)</sup>	\$9,634 <sup>(2)</sup>	\$9,511 <sup>(3)</sup>
Revenues and Transfers	84,471	87,691	92,749
Expenditures	90,026	90,294	92,730
<b>Fund Balance</b>	<b>\$1,943</b>	<b>\$7,031</b>	<b>\$9,530</b>
<i>Reserve for Liquidation of Encumbrances</i>	\$641	\$521	\$521
<i>Special Fund for Economic Uncertainties</i>	\$1,302 <sup>(4)</sup>	\$6,510 <sup>(5)</sup>	\$9,009 <sup>(5)</sup>

(1) Included a carry-over adjustment of \$2.33 billion from amnesty payments, of which \$1.95 billion would have to be refunded or would reduce revenues in future years, including a \$1.05 billion adjustment in fiscal year 2005-06, and \$900 million in fiscal year 2006-07.

(2) Included a carry-over adjustment of \$2.94 billion from amnesty payments, of which \$2.56 billion will have to be refunded or will reduce revenues in future years, including a \$840 million adjustment in 2005-06, \$800 million in 2006-07, and \$920 million in 2007-08 or later.

(3) Includes a carry-over adjustment of \$2.73 billion from amnesty payments, of which \$2.35 billion will have to be refunded or will reduce revenues in future years, including a \$730 million adjustment in 2005-06, \$677 million adjustment in 2006-07 and \$939 million in 2007-08 or later.

(4) Included \$900 million set aside for refunds/accelerations of amnesty related revenue in 2006-07.

(5) Included a carryover amount for refunds/acceleration of amnesty related revenue estimated to be \$920 million, which is expected to be refunded over a longer period of time, beginning in 2007-08. See “PRIOR FISCAL YEARS’ BUDGETS – 2004 Budget Act – Tax Amnesty Program”.

**CURRENT STATE BUDGET**

*The discussion below of the 2006 Budget Act and the table under “Summary of State Revenues and Expenditures” is based on estimates and projections of revenues and expenditures for the 2006-07 fiscal year and must not be construed as statements of fact. These estimates and projections are based upon various assumptions, which may be affected by numerous factors, including future economic conditions in the state and the nation, and there can be no assurance that the estimates will be achieved. See “— Revenue and Expenditure Assumptions.”*

## 2006 Budget Act

The 2006 Budget Act was adopted by the Legislature on June 27, 2006, along with a number of implementing measures, and signed by the Governor on June 30, 2006. In approving the budget, the Governor vetoed \$112 million in appropriations (including \$62 million in General Fund appropriations)

Under the 2006 Budget Act, General Fund revenues and transfers are projected to increase 1.2 percent, from \$92.7 billion in fiscal year 2005-06 to \$93.9 billion in fiscal year 2006-07. The 2006 Budget Act contains General Fund appropriations of \$101.3 billion, compared to \$92.7 billion in 2005-06. This includes more than \$4.9 billion, or 4.7 percent of total General Fund resources available, to address the state's debt by establishing a budget reserve of \$2.1 billion and making early debt repayments of \$2.8 billion. The difference between revenues and expenditures in 2006-07 is funded by using a large part of the 2005-06 ending fund balance, as shown in Figure 1 above. The June 30, 2007 reserve is projected to be \$2.1 billion, compared to an estimated June 30, 2006 reserve of \$9.5 billion.

The 2006 Budget Act is substantially similar to the 2006-07 May Revision proposals. Compared to the 2006-07 May Revision, however, it also assumed \$299 million greater revenues for 2005-06 based on higher than expected revenues in May, and \$19 million greater revenues in 2006-07 due to expanded sales tax licensing and collection programs. The 2006 Budget Act contains the following major General Fund components:

1. Repayments and prepayments of prior obligations – The 2006 Budget Act proposes \$2.812 billion of repayments and/or prepayments of prior obligations as follows: (1) \$1.415 billion for advance payment of a portion of the 2003-04 and 2004-05 Proposition 42 suspensions (includes \$200 million pre-payment from a special fund); (2) \$472 million for early retirement of the Economic Recovery Bonds under Proposition 58; (3) \$296 million to repay/prepay non-Proposition 98 mandates; (4) \$347 million to repay/prepay loans from special funds; (5) \$150 million to prepay Proposition 98 Settle-Up (reflected in prior year and does not affect 2006-07 operating deficit); (6) \$100 million to prepay flood control subventions; and (7) \$32 million set aside to pay debt service on general obligation bonds in fiscal year 2007-08.

2. Reduction of the operating deficit – The 2006 Budget Act projects that after adjusting for repayments or prepayments of prior obligations and one-time investments, the net operating deficit is estimated at \$3.3 billion.

3. Proposition 98 – The 2006 Budget Act proposes Proposition 98 General Fund expenditures at \$41.3 billion, which is an increase of \$2.9 billion, or 7.5 percent, compared to the revised 2005-06 estimate. When property taxes are taken into account, the total Proposition 98 guarantee is \$55.1 billion, which is an increase of \$3.1 billion, or 5.9 percent. The 2006 Budget Act continues to propose to spend at the level of the Proposition 98 guarantee assuming that the 2004-05 suspension had only been \$2 billion. It also continues to include \$426 million above this level to implement Proposition 49. Furthermore, to resolve the pending lawsuit regarding Proposition 98 funding, the state has agreed to calculate the Proposition 98 guarantee consistent with the legislative intent language contained in Chapter 213, Statutes of 2004. As a result, the state will pay \$2.9 billion in settle-up funding, comprised of approximately \$1.6 billion and \$1.3 billion to count toward the Proposition 98 guarantees for 2004-05 and 2005-06, respectively (see Proposition 98).

4. K-12 Education – The 2006 Budget Act proposes \$67.1 billion in spending from all funds on K-12 education, an increase of \$2.9 billion from the revised 2005-06 estimate. General Fund expenditures are proposed at \$40.5 billion (includes funds provided for prior year settle-up obligations),

an increase of \$2.7 billion, or 7 percent. Total per-pupil expenditures from all fund sources are projected to be \$11,264, an increase of \$516, or 4.8 percent from the revised 2005-06 level.

5. Higher Education – The 2006 Budget Act proposes General Fund expenditures at \$11.4 billion, an increase of \$973 million, or 9.4 percent. The 2006 Budget Act marks the second year of funding for the Higher Education Compact. The Compact was signed in Spring 2004 with both UC and CSU to provide funding stability and preserve educational quality over the following six fiscal years in exchange for improved accountability in a variety of key student performance measures. The 2006 Budget Act proposes additional funding of \$75 million for UC and \$54.4 million for CSU so that student fees in 2006-07 will remain at current 2005-06 levels.

6. Health and Human Services – The 2006 Budget Act proposes \$29.3 billion General Fund to be spent on Health and Human Services programs, which is an increase of \$2.5 billion, or 8.7 percent, from the revised 2005-06 estimate. This increase is primarily due to caseload, population, and other workload increases as well as a one-time investment of \$214 million (\$180 million General Fund) on health care surge capacity needs.

7. Transportation Funding – The 2006 Budget Act includes \$1.42 billion to fully fund Proposition 42 in 2006-07 and \$1.415 billion, including interest, for advance payment of a portion of the 2003-04 and 2004-05 Proposition 42 suspensions (\$200 million to be repaid from a special fund). The 2005 Budget Act assumed repayment of a portion of outstanding transportation loans with \$1 billion in bond proceeds derived from certain Indian gaming revenues to specified transportation programs. This transportation funding package would have provided \$465 million to the State Highway Account, \$290 million to the Traffic Congestion Relief Program, \$122 million to the Public Transportation Account, and \$122 million to cities and counties. There have been several lawsuits that have prevented the bonds from being sold to date, and the 2006 Budget Act instead repays \$151 million of these loans to the State Highway Account in 2005-06 using cash already received from tribal gaming compacts. Bond proceeds in the amount of \$849 million are now budgeted in 2006-07, which would provide \$314 million to the State Highway Account, and would provide the same level of funding to the Traffic Congestion Relief Program, Public Transportation Account, and cities and counties as was originally proposed. See “LITIGATION – Actions Seeking to Enjoin Implementation of Certain Tribal Gaming Compacts” below.

8. Budget Stabilization Account – The 2006 Budget Act fully funds the transfer of an estimated \$944 million to the Budget Stabilization Account (BSA), pursuant to Proposition 58. Half of this amount, or \$472 million, will remain in the BSA as a reserve. The other half will be further transferred for the purpose of early retirement of Economic Recovery Bonds. These transfers took place in September, 2006.

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Budget Summary for Fiscal Year 2006-07

Set forth below is a chart showing a General Fund Budget Summary for fiscal year 2006-07 as originally projected by the 2006-07 Governor's Budget, and as further revised by the 2006 Budget Act.

**FIGURE 2**

**2006-07 General Fund Budget Summary  
(Millions)**

	<b>As of 2006-07 Governor's Budget</b>	<b>As of 2006 Budget Act</b>
<b>Prior Year Resources Available</b>	\$7,031 <sup>(1)</sup>	\$9,530 <sup>(2)</sup>
Revenues and Transfers	91,545	93,882
Expenditures	97,902	101,261
<b>Fund Balance</b>	<b>\$674</b>	<b>\$2,151</b>
<i>Reserve for Liquidation of Encumbrances</i>	\$521	\$521
<i>Special Fund for Economic Uncertainties</i>	\$153	\$1,630
<i>Budget Stabilization Account</i>	\$460	\$472
<b>Total Available Reserve</b>	<b>\$613</b>	<b>\$2,102</b>

(1) Included a carry-over adjustment of \$2.1 billion from amnesty payments, of which \$1.72 billion will have to be refunded or will reduce revenues in future years, including a \$800 million adjustment in 2006-07 and \$920 million in 2007-08 or later.

(2) Includes a carry-over adjustment of \$2 billion from amnesty payments, of which \$1.62 billion will have to be refunded or will reduce revenues in future years, including a \$677 million adjustment in 2006-07 and a \$939 million adjustment in 2007-08 or later.

**Strategic Growth Plan**

In January 2006, the Governor proposed a comprehensive Strategic Growth Plan to build the critical infrastructure that is the foundation of the state's economy. In May, the Legislature approved a \$115.8 billion Strategic Growth Plan package, which includes \$37.3 billion in new general obligation bonds which were approved by the voters at the November 7, 2006 election, \$50.1 billion in existing funding, and \$28.4 billion in new leveraged funding sources. The package consists of the following components:

1. Education -- \$10.4 billion in new general obligation bonds for K-12 and Higher Education facilities. In addition, local school districts will provide \$4.0 billion as their match for the new funds, and \$3.6 billion in remaining, previously authorized general obligation bonds will be fully apportioned to help the needs of local districts.

2. Transportation -- \$19.9 billion in new general obligation bonds for transportation and air quality projects. Existing sources for transportation projects include \$26.4 billion in state and federal fuel



taxes that are being used for capital purposes. Additionally, \$526 million is expected to be available from tribal gaming revenues and bonds and \$8.6 billion from Proposition 42. The additional funding made available due to reauthorization of federal transit and highway funding law is estimated to make \$10 billion available over the next 10 years. Savings in the CalTrans support budget are expected to generate \$375 million over the next decade. New funding sources for transportation projects include \$9 billion from the portion of revenues from new and renewed local sales tax measures that historically has been used for projects in the state system. Additionally, \$3.1 billion in Grant Anticipation Revenue Vehicle (GARVEE) bonding against future federal revenues is available. Lastly, initial estimates are that private funding may provide as much as \$8 billion.

3. Flood Protection -- \$4.1 billion in new general obligation bonds for levee repair and flood control projects. In addition, between new local matching funds and contributions from the federal government, over \$3.5 billion of other funds will be invested into the various projects. Finally, a \$500 million General Fund appropriation made from 2005-06 fiscal year funds (AB 142, Chapter 34, Statutes of 2006), will be used for the repair and improvement of critical levees.

4. Housing -- \$2.9 billion in new general obligation bonds for housing construction and assistance, including homeownership programs, affordable rental housing construction, farm worker housing, and housing for the homeless and foster care youth.

### **LAO Assessment of the 2006 Budget Act**

The Legislative Analyst's Office ("LAO") released a summary of the 2006 Budget Act in July, 2006, titled "Major Features of the 2006 California Budget," consistent with the brief overview above. In a section titled "Out-Year Implications of the 2006-07 Budget" the LAO stated:

"Based on our current projections of revenues and expenditures under the 2006-07 Budget Act policies, the state would continue to face operating shortfalls in the range of \$4.5 billion to \$5 billion in 2007-08 and 2008-09. The carryover reserve from 2006-07 would be available to offset a portion of the shortfall in 2007-08. We will be updating our fiscal projections in November 2006, when we release our *California Fiscal Outlook*."

LAO is scheduled to release a report titled "California Fiscal Outlook" on November 15, 2006, which will contain revenue and other budget projections for the next five years. These projections do not represent formal state policy. Publications from the LAO can be read in full by accessing the LAO's website ([www.lao.ca.gov](http://www.lao.ca.gov)) or by contacting the LAO at (916) 445-4656.

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## Summary of State Revenues and Expenditures

The table below presents the actual revenues, expenditures and changes in fund balance for the General Fund for fiscal years 2002–03, 2003–04, and 2004–05, estimated results for fiscal years 2005–06 and 2006–07.

**TABLE 17**  
**Statement of Revenues, Expenditures,**  
**And Changes in Fund Balance—General Fund**  
**(Budgetary Basis)<sup>(a)</sup>**  
**Fiscal Years 2002–03 Through 2006–07**  
**(Millions)**

	2002–03	2003–04	2004–05	Estimated <sup>(b)</sup> 2005–06 <sup>(c)</sup>	Estimated <sup>(b)</sup> 2006–07 <sup>(c)</sup>
<b>Fund Balance—Beginning of Period .....</b>	\$ (2,109.8)	\$ (7,536.2)	\$ 3,309.4	\$ 9,922.7	\$9,530.1
Restatements					
Prior Year Revenue, Transfer Accrual					
Adjustments <sup>(d)</sup> .....	154.4	2,626.1	3,785.4	(202.6)	--
Prior Year Expenditure, Accrual					
Adjustments .....	<u>374.2</u>	<u>512.7</u>	<u>313.7</u>	<u>(208.5)</u>	<u>--</u>
<b>Fund Balance—Beginning of Period, as</b>					
<b>Restated .....</b>	\$ (1,581.2)	\$ (4,397.4)	\$ 7,408.5	\$ 9,511.6	\$9,530.1
Revenues.....	\$68,545.8	\$74,149.8	\$81,980.0	\$92,774.1	\$94,512.0
Other Financing Sources					
Economic Recovery Bonds <sup>(e)</sup> .....	—	11,254.0	—	—	—
Transfers from Other Funds .....	3,289.5	914.8	359.9	(25.5)	(629.7)
Other Additions .....	<u>143.9</u>	<u>124.9</u>	<u>83.8</u>	<u>—</u>	<u>—</u>
<b>Total Revenues and Other Sources .....</b>	<b>\$71,979.2</b>	<b>\$86,443.5</b>	<b>\$82,423.7</b>	<b>\$92,748.6</b>	<b>\$93,882.3</b>
Expenditures					
State Operations.....	\$18,277.6	\$19,498.2	\$17,966.1 <sup>(f)</sup>	\$21,487.1	\$23,838.0
Local Assistance .....	59,145.3	58,610.8	61,674.4	69,287.2	74,195.7
Capital Outlay .....	141.3	348.7	65.1	1,955.8	2,911.2
Unclassified .....	—	—	—	--	316.1
Other Uses					
Transfer to Other Funds .....	<u>370.0</u>	<u>279.0</u>	<u>203.9</u>	<u>—<sup>(g)</sup></u>	<u>—<sup>(g)</sup></u>
<b>Total Expenditures and Other Uses .....</b>	<b>\$ 77,934.2</b>	<b>\$78,736.7</b>	<b>\$79,909.5</b>	<b>\$92,730.1</b>	<b>\$101,261.0</b>
<b>Revenues and Other Sources Over or</b>					
<b>(Under) Expenditures and Other Uses .....</b>	<b>\$ (5,955.0)</b>	<b>\$ 7,706.8</b>	<b>\$2,514.2</b>	<b>\$ 18.5</b>	<b>\$(7,378.7)</b>
Fund Balance					
Reserved for Encumbrances .....	\$ 1,037.4	\$ 641.4	\$ 540.4	\$ 521.3	\$521.3
Reserved for Unencumbered Balances of					
Continuing Appropriations <sup>(h)</sup> .....	996.9	902.1	858.7	423.6	28.8
Unreserved—Undesignated <sup>(i)</sup> .....	<u>(9,570.5)</u>	<u>1,765.9</u>	<u>8,523.6</u>	<u>8,585.2</u>	<u>1,601.3</u>
<b>Fund Balance—End of Period .....</b>	<b>\$ (7,536.2)</b>	<b>\$ 3,309.4</b>	<b>\$9,922.7</b>	<b>\$ 9,530.1</b>	<b>\$2,151.4</b>

Footnotes on following page.

Source: Fiscal years 2002–03 to 2004–05: State of California, Office of the State Controller.  
Fiscal years 2005–06 and 2006–07: State of California, Department of Finance.

- (a) These statements have been prepared on a budgetary basis in accordance with state law and some modifications would be necessary in order to comply with generally accepted accounting principles ("GAAP"). The Supplementary Information contained in the state's Audited Basic Financial Statements for the year ended June 30, 2005, incorporated by reference in this APPENDIX A, contains a description of the differences between the budgetary basis and the GAAP basis of accounting and a reconciliation of the June 30, 2005 fund balance between the two methods. See "FINANCIAL STATEMENTS."
- (b) Estimates are shown net of reimbursements and abatements.
- (c) Estimated as of the 2006 Budget Act, June 30, 2006.
- (d) Figures for fiscal years 2003-04 and 2004-05 are higher due to a change in accounting for prior year revenues collected by the Franchise Tax Board ("FTB") for the Voluntary Compliance Initiative revenue. FTB now recognizes audit findings as prior year revenue collected.
- (e) Reflects the issuance of economic recovery bonds sufficient to provide net proceeds to the General Fund of \$11.254 billion in 2003-04 to finance the negative General Fund reserve balance as of June 30, 2004, and other General Fund obligations undertaken prior to June 30, 2004. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS—Economic Recovery Bonds." \$2.012 billion of this amount is budgeted as an expenditure reduction in fiscal year 2004-05.
- (f) Reflects General Fund payment offsets from moneys deposited in the Deficit Recovery Fund (\$2.012 billion).
- (g) "Transfer to Other Funds" is included either in the expenditure totals detailed above or as "Transfers from Other Funds."
- (h) For purposes of determining whether the General Fund budget, in any given fiscal year, is in a surplus or deficit condition, see Chapter 1238, Statutes of 1990, amended Government Code Section 13307. As part of the amendment, the unencumbered balances of continuing appropriations which exist when no commitment for an expenditure is made should be an item of disclosure, but the amount shall not be deducted from the fund balance. Accordingly, the General Fund condition included in the 2006-07 Governor's Budget includes the unencumbered balances of continuing appropriations as a footnote to the statement (\$880.7 million in fiscal year 2004-05, \$423.6 million in fiscal year 2005-06, and \$28.8 million in fiscal year 2006-07). However, in accordance with Government Code Section 12460, the State's Budgetary/Legal Basis Annual Report reflects a specific reserve for the encumbered balance for continuing appropriations.
- (i) Includes Special Fund for Economic Uncertainties ("SFEU"). The Department of Finance generally includes in its estimates of the SFEU and set aside reserves, if any, the items reported in the table under "Reserved for Unencumbered Balances of Continuing Appropriations," and "Unreserved—Undesignated." The Department of Finance estimates a \$9.009 billion SFEU balance on June 30, 2006, and projects a \$1,630 million SFEU balance on June 30, 2007, based upon the 2006 Budget Act enacted June 30, 2006. In addition to the SFEU, as of June 30, 2007, there is projected to be an additional reserve of \$472 million in the Budget Stabilization Account (BSA) available to transfer to the General Fund through statute. The total available reserve, including the BSA, is projected to be \$2.102 billion as of June 30, 2007. The BSA was created pursuant to the California Balanced Budget Act (Proposition 58), enacted in 2004.

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## Revenue and Expenditure Assumptions

The table below presents the Department of Finance's budget basis statements of major General Fund revenue sources and expenditures for the 2006 Budget Act estimates for the 2005-06 and 2006-07 fiscal years.

**TABLE 18**

### Major General Fund Revenue Sources and Expenditures

Source	Revenues (Millions)		
	2005-06 <sup>(a)</sup> Enacted	2005-06 <sup>(b)</sup> Revised	2006-07 <sup>(b)</sup> Enacted
Personal Income Tax.....	\$43,230	\$49,555	\$50,885
Sales and Use Tax.....	26,951	27,211	28,114
Corporation Tax.....	8,822	10,484	10,507
Insurance Tax.....	2,300	2,247	2,340
All Other.....	3,168 <sup>(c)</sup>	3,252 <sup>(d)</sup>	2,036 <sup>(e)</sup>
Total Revenues and Transfers	<u>\$84,471</u>	<u>\$92,749</u>	<u>\$93,882</u>

Function	Expenditures (Millions)		
	2005-06 <sup>(a)</sup> Enacted	2005-06 <sup>(b)</sup> Revised	2006-07 <sup>(b)</sup> Enacted
K-12 Education.....	\$36,583	\$37,855	\$40,510
Health and Human Services.....	27,115	26,965	29,304
Higher Education.....	10,217	10,395	11,368
Corrections and Rehabilitation.....	7,422	7,838	8,751
Legislative, Judicial and Executive.....	3,057	3,093	3,417
Tax Relief <sup>(f)</sup> .....	675	671	679
Resources.....	1,356	1,885 <sup>(g)</sup>	1,826
State and Consumer Services.....	562	576	576
Business, Transportation and Housing.....	1,702 <sup>(h)</sup>	1,723 <sup>(i)</sup>	3,029 <sup>(j)</sup>
All Other.....	1,337 <sup>(k)</sup>	1,729 <sup>(l)</sup>	1,801 <sup>(m)</sup>
Total Expenditures	<u>\$90,026</u>	<u>\$92,730</u>	<u>\$101,261</u>

Source: State of California, Department of Finance. Figures in this table may differ from the figures in Table 4; see "Note" to Table 4.

(a) 2005 Budget Act, July 11, 2005.

(b) 2006-07 Budget Act, June 30, 2006.

(c) Includes \$252 million from pension obligation bonds.

(d) Includes \$525 million due to the refunding of the tobacco securitization bonds and \$0 from pension obligation bonds.

(e) Includes -\$472 million (budgeted as a revenue reduction) transferred to the Budget Stabilization Account to remain in the rainy day fund.

(f) Reflects the elimination of VLF "backfill" payments to local governments.

(g) Reflects \$500 million for levee evaluation and flood control system improvements.

(h) Reflects \$1.313 billion in Proposition 42 transfers from the General Fund to the Transportation Investment Fund.

(i) Reflects \$1.355 billion in Proposition 42 transfers from the General Fund to the Transportation Investment Fund.

Footnotes continue on following page.

- (j) Reflects \$1.420 billion in Proposition 42 transfers from the General Fund to the Transportation Investment Fund and \$1.215 million partial early repayment of the 2003-04 and 2004-05 Proposition 42 suspensions.
- (k) Reflects reduced expenditures of \$308 million due to the anticipated receipt of pension obligation bond proceeds to cover General Fund contributions to pension funds; reflects a \$1.187 billion payment to fully repay the amount that local governments lost between July and October 2003 when the Vehicle License Fee offset program was temporarily suspended.
- (l) Reflects \$1.187 billion to fully repay the amount that local governments lost between July and October 2003 when the Vehicle License Fee offset program was temporarily suspended; assumes no pension obligation proceeds.
- (m) Reflects \$472 million transfer to the Budget Stabilization Account for early retirement of the Economic Recovery Bonds.

## **Development of Revenue Estimates**

The development of the forecast for the major General Fund revenues begins with a forecast of national economic activity prepared by an independent economic forecasting firm. The Department of Finance's Economic Research Unit, under the direction of the Chief Economist, adjusts the national forecast based on the Department's economic outlook. The national economic forecast is used to develop a forecast of similar indicators for California activity.

After finalizing the forecasts of major national and California economic indicators, revenue estimates are generated using revenue forecasting models developed and maintained by the Department of Finance. With each forecast, adjustments are made for any legislative, judicial, or administrative changes, as well as for recent cash results. The forecast is updated twice a year and released with the Governor's Budget by January 10 and the May Revision by May 14.

## **Economic Assumptions**

The revenue and expenditure assumptions set forth above have been based upon certain estimates of the performance of the California and national economies in calendar years 2006 and 2007. In the 2006–07 May Revision, the Department of Finance projected that both economies will decelerate slightly in calendar years 2006 and 2007 largely because of slowing residential construction and real estate markets and rising interest rates but continue to grow at rates close to long-run average growth.

Both the California economy and the national economy improved in 2005 and the first five months of 2006. National economic output grew by 3.5 percent in 2005—a solid gain coming on top of an even better 4.2 percent increase in 2004. The national economy was not as strong in the second half of 2005 as it was in the first half, however. Hurricane destruction, high energy costs, rising interest rates, and a cooling housing sector sapped some of its vitality, and economic output grew at an annualized rate of only 1.7 percent in the fourth quarter of 2005. The economy rebounded in the first quarter of 2006, but recent monthly data suggest that growth decelerated again in the second quarter. The slowing of economic growth is reflected in average monthly job growth, which so far in 2006 is smaller than the average gain in all of 2005. Smaller increases in construction employment account for about a third of the decline in job gains. Still, job gains remain widespread across major industry sectors, and the national unemployment rate has continued to decline, reaching 4.6 percent in May. The cooling of the nation's housing sector is evident in new and existing home sales, which after reaching record annual highs last summer, have trended downward. In addition, single-family housing starts, after reaching a record annual high in 2005, have fallen by 13 percent since January 2006. Rising energy prices have boosted measures of general inflation in the last two years, but until recently, measures of general inflation that exclude energy prices were quite stable. Now, however, even these measures are showing signs that inflation is picking up—a development that is of concern to the Federal Reserve.

Adjusted for inflation, California economic output grew by 4.4 percent in 2005, the 15<sup>th</sup> best performance of the 50 states. California total personal income increased by 6.3 percent in 2005, down somewhat from 6.6 percent growth in 2004, but slightly better than the average gain in personal income from 1984 to 2004. Wage and salary income expanded by 6.5 percent in 2005, stronger than the 6 percent

gain in 2004. Statewide taxable sales grew by 5.9 percent in 2005, in line with personal income growth but down from the 8.7 percent gain in taxable sales in 2004. Made-in-California merchandise exports expanded by 6.2 percent in 2005 and were 7.3 percent higher than a year earlier in the first quarter of 2006. Increased exports to Mexico, Japan and mainland China accounted for over three-quarters of the total gain in exports. Mainland China was the fourth largest recipient of California merchandise exports in the first quarter.

As in the national economy, high energy costs, rising interest rates, and a cooling housing sector slowed California economic growth in the first five months of 2006. Average monthly job gains fell from 24,000 in all of 2005 to 9,000 in the first five months of 2006. About half of the decline was due to a loss of 11,400 construction jobs, which was in part due to rainy weather. Still, unemployment was low in May at 5.0 percent, down from 5.4 percent a year earlier.

Existing home sales fell for the second straight quarter in the first quarter of 2006, pushing them 18 percent below year-ago sales. At \$549,000, the median price of existing single-family homes sold in the first quarter of 2006 was essentially unchanged from the third quarter of 2005. Residential permits were down 13 percent from a year earlier in the first five months of 2006, with single-family permits off 19 percent but multifamily permits up 6 percent.

The valuation of nonresidential building permits rose by 22 percent in the first five months of 2006, however.

The 2006-07 May Revision projected national output growth will slow somewhat in 2006 and again in 2007. California personal income growth is expected to slow slightly in 2006 and more so in 2007. National housing starts and California housing permits are projected to fall in both years.

The Department of Finance sets out the following estimates for the state's economic performance in calendar years 2006 and 2007, which were used in predicting revenues and expenditures for the 2006-07 May Revision and the 2006 Budget Act. Also shown is the Department of Finance's previous forecast for the same calendar years, which was contained in the 2006-07 Governor's Budget.

**TABLE 19****Estimates of State's Economic Performance**

	<b>For Calendar Year 2006</b>		<b>For Calendar Year 2007</b>	
	<b>2006-07 Governor's Budget<sup>(a)</sup></b>	<b>2006-07 May Revision<sup>(b)</sup></b>	<b>2006-07 Governor's Budget<sup>(a)</sup></b>	<b>2006-07 May Revision<sup>(b)</sup></b>
Non-farm wage and salary employment (000)	14,914	15,029	15,104	15,255
Percent Change	1.3%	1.6%	1.3%	1.5%
Personal income (\$ billions)	\$1,415	\$1,425	\$1,493	\$1,507
Percent Change	5.8%	6.2%	5.5%	5.8%
Housing Permits (Units 000)	197	190	183	175
Consumer Price Index (percent change)	3.6%	3.6%	3.0%	2.9%

(a) Fiscal Year 2006-07 Governor's Budget Summary: January 10, 2006.

(b) 2006-07 May Revision, May 12, 2006.

Source: State of California, Department of Finance.

**FINANCIAL STATEMENTS**

The Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2005 (the "Financial Statements") are available. As of June 30, 2002, the State of California has implemented a new financial reporting model, as required by the Governmental Accounting Standards Board ("GASB") in conformity with accounting principles generally accepted in the United States of America. The GASB sets standards of accounting and financial reporting for state and local governments, which have significantly changed the presentation of the financial statements. The Financial Statements consists of an Independent Auditor's Report, a Management Discussion and Analysis, Basic Financial Statements of the state for the Year Ended June 30, 2005 ("Basic Financial Statements"), and Supplementary Information. Only the Basic Financial Statements have been audited, as described in the Independent Auditor's Report. A description of the new accounting and financial reporting standards is contained in Note 1 of the Basic Financial Statements.

Potential investors may also obtain or review a copy of the Financial Statements from the following sources:

1. By obtaining, from any Nationally Recognized Municipal Securities Information Repository, or any other source, a copy of the State of California's Official Statement dated June 14, 2006 for \$700,000,000 State of California Various Purpose General Obligation Bonds and \$314,135,000 General Obligation Refunding Bonds. The Financial Statements are printed in full in such Official Statement. No part of the June 14, 2006 Official Statement is incorporated into this document except for the Financial Statements.

2. By accessing the internet website of the State Controller ([www.sco.ca.gov](http://www.sco.ca.gov)) and selecting "Publications" and then selecting "State Government Annual Financial Reports," or by contacting the Office of the State Controller at (916) 445-2636.

3. By accessing the internet website of the State Treasurer ([www.treasurer.ca.gov](http://www.treasurer.ca.gov)) and under the heading “Inside the Treasurer’s Office” selecting “Bonds – Public Finance,” and then under the heading “Financial Information,” selecting “Recent Financial Information” or by contacting the Office of the State Treasurer at (800) 900-3873.

The State Controller’s unaudited reports of cash receipts and disbursements for the periods of July 1, 2005 to June 30, 2006, and from July 1, 2006 through October 31, 2006, are included as Exhibits 1 and 2 to this APPENDIX A. These reports, and the General Fund Cash Basis Report for the Year Ended June 30, 2006, are available on the State Controller’s website.

Periodic reports on revenues and/or expenditures during the fiscal year are issued by the Administration, the State Controller’s Office and the Legislative Analyst’s Office. The State Controller issues a monthly report on cash receipts and disbursements recorded on the State Controller’s records. The Department of Finance issues a monthly bulletin, available by accessing the internet website of the Department of Finance ([www.dof.ca.gov](http://www.dof.ca.gov)), which reports the most recent revenue receipts as reported by state departments, comparing those receipts to budget projections. The Administration also formally updates its budget projections three times during each fiscal year, in January, May, and at the time of budget enactment. These bulletins and reports are available on the internet at websites maintained by the agencies and by contacting the agencies at their offices in Sacramento, California. Such bulletins and reports are not part of or incorporated into the Official Statement. Investors are cautioned that interim financial information is not necessarily indicative of results for a fiscal year. Information which may appear in the Official Statement from the Department of Finance concerning monthly receipts of “agency cash” may differ from the State Controller’s reports of cash receipts for the same periods because of timing differences in the recording of in-transit items.

## **INVESTMENT OF STATE FUNDS**

Moneys on deposit in the State’s Centralized Treasury System are invested by the State Treasurer in the Pooled Money Investment Account (“PMIA”). As of October 31, 2006, the PMIA held approximately \$42.0 billion of state moneys, and \$14.9 billion invested for about 2,613 local governmental entities through the Local Agency Investment Fund (“LAIF”). The assets of the PMIA as of October 31, 2006, are shown in the following table:



**TABLE 20****Analysis of the Pooled Money Investment Account Portfolio\***

<b>Type of Security</b>	<b>Amount (Thousands)</b>	<b>Percent of Total</b>
U.S. Treasury	\$2,060,945	3.6%
Commercial Paper	8,508,930	15.0
Certificates of Deposits	11,903,277	20.9
Corporate Bonds	560,870	1.0
Federal Agency	14,960,569	26.3
Bankers Acceptances	--	0.0
Bank Notes	1,250,025	2.2
Loans Per Government Code	9,517,492	16.7
Time Deposits	8,303,495	14.6
Repurchases	--	0.0
Reverse Repurchases	(198,5200)	0.0
	<u>\$56,867,086</u>	<u>100.0%</u>

\* Totals may differ due to rounding.

Source: State of California, Office of the State Treasurer.

The state's treasury operations are managed in compliance with the California Government Code and according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. The PMIA operates with the oversight of the PMIB. The LAIF portion of the PMIA operates with the oversight of the Local Agency Investment Advisory Board (consisting of the State Treasurer and four other appointed members).

The State Treasurer does not invest in leveraged products or inverse floating rate securities. The investment policy permits the use of reverse repurchase agreements subject to limits of no more than 10 percent of the PMIA. All reverse repurchase agreements are cash matched either to the maturity of the reinvestment or an adequately positive cash flow date which is approximate to the maturity of the reinvestment.

The average life of the investment portfolio of the PMIA as of October 31, 2006 was 190 days.

## **OVERVIEW OF STATE GOVERNMENT**

### **Organization of State Government**

The State Constitution provides for three separate branches of government: the legislative, the judicial and the executive. The Constitution guarantees the electorate the right to make basic decisions, including amending the Constitution and local government charters. In addition, the state voters may directly influence state government through the initiative, referendum and recall processes.

California's Legislature consists of a forty-member Senate and an eighty-member Assembly. Assembly members are elected for two-year terms, and Senators are elected for four-year terms. Assembly members are limited to three terms in office and Senators to two terms. The Legislature meets almost year round for a two-year session. The Legislature employs the Legislative Analyst, who provides reports on state finances, among other subjects. The Bureau of State Audits, headed by the State Auditor,

an independent office since 1993, annually issues an auditor's report based on an examination of the General Purpose Financial Statements of the State Controller, in accordance with generally accepted accounting principles. See "FINANCIAL STATEMENTS."

The Governor is the chief executive officer of the state and is elected for a four-year term. The Governor presents the annual budget and traditionally presents an annual package of bills constituting a legislative program. In addition to the Governor, state law provides for seven other statewide elected officials in the executive branch. The current elected statewide officials, their party affiliation and the dates on which they were first elected are as follows:

<b><u>Office</u></b>	<b><u>Name</u></b>	<b><u>Party Affiliation</u></b>	<b><u>First Elected</u></b>
Governor	Arnold Schwarzenegger	Republican	2003
Lieutenant Governor	Cruz Bustamante	Democrat	1998
Controller	Steve Westly	Democrat	2002
Treasurer	Philip Angelides	Democrat	1998
Attorney General	Bill Lockyer	Democrat	1998
Secretary of State	Bruce McPherson <sup>(a)</sup>	Republican	-
Superintendent of Public Instruction	Jack O'Connell	Democrat	2002
Insurance Commissioner	John Garamendi	Democrat	2002

(a) Confirmed by the Legislature and sworn in as Secretary of State on March 30, 2005.

The current term for each office expires in January 2007 except for Mr. O'Connell, who was re-elected to a second term in the June 2006 primary election. Persons elected to statewide offices are limited to two terms in office (eight years) from the dates shown above. At the November 7, 2006 election, the following persons were elected to statewide offices to commence terms on January 8, 2007:

<b><u>Office</u></b>	<b><u>Name</u></b>	<b><u>Party Affiliation</u></b>
Governor	Arnold Schwarzenegger	Republican
Lieutenant Governor	John Garamendi	Democrat
Controller	John Chiang	Democrat
Treasurer	Bill Lockyer	Democrat
Attorney General	Jerry Brown	Democrat
Secretary of State	Deborah Bowen	Democrat
Insurance Commissioner	Steve Poizner	Republican

The executive branch is principally administered through eleven major agencies and departments: Business, Transportation and Housing Agency, Child Development and Education Agency, Environmental Protection Agency, Department of Finance, Department of Food and Agriculture, Health and Human Services Agency, Labor and Workforce Development Agency, Resources Agency, State and Consumer Services Agency, Department of Veterans Affairs and a new Department of Corrections and Rehabilitation, which took over the functions of the Youth and Adult Correctional Agency as of July 1, 2005. In addition, some state programs are administered by boards and commissions, such as The Regents of the University of California, Public Utilities Commission, Franchise Tax Board and California Transportation Commission, which have authority over certain functions of state government with the power to establish policy and promulgate regulations. The appointment of members of boards and commissions is usually shared by the Legislature and the Governor, and often includes ex officio members.

California has a comprehensive system of public higher education comprised of three segments: the University of California, the California State University System and California Community Colleges. The University of California provides undergraduate, graduate and professional degrees to students. Approximately 54,500 degrees were awarded in the 2004-05 school year. Approximately 206,700 full-time students were enrolled at the ten UC campuses and the Hastings College of Law in the 2005-06 school year. (The newest campus, at Merced, opened to graduate students in 2004, and to undergraduates in the fall of 2005.) The California State University System provides undergraduate and graduate degrees to students. Approximately 84,000 degrees were awarded in the 2004-05 school year. About 332,200 full-time students were enrolled at the 23 campuses in the 2005-06 school year. The third sector consists of 109 campuses operated by 72 community college districts, which provide associate degrees and certificates to students. Additionally students may attend community colleges to meet basic skills and other general education requirements prior to transferring to a four-year undergraduate institution. More than 99,000 associate degrees and certificates were awarded in the 2004-05 school year. Over 1.6 million students were enrolled in California's community colleges in the spring of 2005.

### **Employee Relations**

In 2005-06, the state work force is comprised of approximately 334,000 positions, of which approximately 116,000 positions represent employees of institutions of higher education. Of the remaining 218,000 positions, approximately 182,000 are subject to collective bargaining and approximately 36,000 are excluded from collective bargaining. State law provides that state employees, defined as any civil service employee of the state and teachers under the jurisdiction of the Department of Education or the Superintendent of Public Instruction, and excluding certain other categories, have a right to form, join, and participate in the activities of employee organizations for the purpose of representation on all matters of employer-employee relations. The chosen employee organization has the right to represent its members, except that once an employee organization is recognized as the exclusive representative of a bargaining unit, only that organization may represent employees in that unit.

The scope of representation is limited to wages, hours, and other terms and conditions of employment. Representatives of the Governor are required to meet and confer in good faith and endeavor to reach agreement with the employee organization, and, if agreement is reached, to prepare a memorandum of understanding and present it to the Legislature for ratification. The Governor and the recognized employee organization are authorized to agree mutually on the appointment of a mediator for the purpose of settling any disputes between the parties, or either party could request the Public Employment Relations Board to appoint a mediator.

There are twenty-one collective bargaining units that represent state employees. Of the twenty-one bargaining units, twenty have negotiated new contracts; one contract expires in July 2007, eighteen contracts expire in July 2008, and one contract expires in July 2010. For the unit that does not have a signed contract, the terms of the prior agreement remain in effect. The Department of Personnel Administration is continuing to negotiate with these units. The state has not experienced a major work stoppage since 1972. The California State Employees' Association is the exclusive representative for nine of the twenty-one collective bargaining units, or approximately 50 percent of those represented employees subject to collective bargaining. Their contracts are pending ratification. Each of the remaining exclusive representatives represents only one bargaining unit.

## **ECONOMY AND POPULATION**

### **Introduction**

California's economy, the largest among the 50 states and one of the largest in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, tourism, construction and services. In early 2001, California's economy slipped into a recession, which was concentrated in the state's high-tech sector and, geographically, in the San Francisco Bay Area. The economy has since recovered with 604,800 jobs gained between July 2003 and May 2006 compared with 367,600 jobs lost between January 2001 and July 2003. See "CURRENT STATE BUDGET—Economic Assumptions."

### **Population and Labor Force**

The state's July 1, 2005 population of about 37 million represented over 12 percent of the total United States population. California is by far the most populous state in the nation, almost two-thirds larger than the second-ranked state according to the 2000 U.S. Census. California has grown about twice as rapidly as the national population during the last half of the 20th century, averaging about 26% growth for each decade between 1950 and 2000. Although California's growth slowed during the 1990s, and is not expected to match the levels of the earlier decades before 1990, it is still expected to be in the range of 1 to 1.5% annually through at least the end of this decade. Population growth is expected to be about equally due to natural increase (excess of births over deaths) and net migration into the state.

Population growth in the next five years is expected to be largest in the over age 65 category, with above statewide average growth in the working age and college age categories. School age and preschool categories will have lower than statewide average growth, reflecting lower births in the state during the 1990s when the current and near future school age population was born.

California's population is perhaps the most diverse in the nation. As of the 2000 Census, no single ethnic group constituted a majority of the population. It is estimated that within the next 10-15 years, the Latino population will be the largest ethnic group in the state.

California's population is concentrated in metropolitan areas. As of the April 1, 2000 census, 97 percent resided in the 25 Metropolitan Statistical Areas in the state. As of July 1, 2004, the 5-county Los Angeles area accounted for 49 percent of the state's population, with over 17.0 million residents, and the 11-county San Francisco Bay Area represented 20 percent, with a population of over 7.0 million.

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The following table shows California's population data for 1995 through 2005.

**TABLE 21**

**Population 1995-2005<sup>(a)</sup>**

<b>Year</b>	<b>California Population</b>	<b>% Increase Over Preceding Year</b>	<b>United States Population</b>	<b>% Increase Over Preceding Year</b>	<b>California as % of United States</b>
1995	31,712,000	0.6%	266,278,393	1.2%	11.9%
1996	31,963,000	0.8	269,394,284	1.2	11.9
1997	32,453,000	1.5	272,646,925	1.2	11.9
1998	32,863,000	1.3	275,854,104	1.2	11.9
1999	33,419,000	1.7	279,040,168	1.2	12.0
2000	34,099,000	2.0	282,193,477	1.1	12.1
2001	34,784,000	2.0	285,107,923	1.0	12.2
2002	35,393,000	1.7	287,984,799	1.0	12.3
2003	35,990,000	1.7	290,850,005	1.0	12.4
2004	36,506,000	1.4	293,656,842	1.0	12.4
2005	37,005,000	1.4	296,410,404	0.9	12.5

(a) Population as of July 1.

Source: U. S. figures from U.S. Department of Commerce, Bureau of the Census; California figures from State of California, Department of Finance.

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The following table presents civilian labor force data for the resident population, age 16 and over, for the years 1995 to 2005.

**TABLE 22**  
**Labor Force 1995-2005**  
**(Thousands)**

<b>Year</b>	<b>Labor Force</b>	<b>Employment</b>	<b>Unemployment Rate (%)</b>	
			<b>California</b>	<b>United States</b>
1995	15,264	14,062	7.9%	5.6%
1996	15,436	14,304	7.3	5.4
1997	15,793	14,792	6.4	4.9
1998	16,167	15,204	6.0	4.5
1999	16,431	15,567	5.3	4.2
2000	16,858	16,024	4.9	4.0
2001	17,152	16,220	5.4	4.7
2002	17,331	16,168	6.7	5.8
2003	17,404	16,213	6.7	6.0
2004	17,655	16,576	6.2	5.5
2005	17,696	16,747	5.4	5.1

Source: State of California, Employment Development Department.

### **Employment, Income, Construction and Export Growth**

The following table shows California's non-agricultural employment distribution and growth for 1995 and 2005.

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**TABLE 23****Payroll Employment By Major Sector  
1995 and 2005**

<b>Industry Sector</b>	<b>Employment (Thousands)</b>		<b>% Distribution of Employment</b>	
	<b>1995</b>	<b>2005</b>	<b>1995</b>	<b>2005</b>
Trade, Transportation and Utilities	2,398.2	2,814.4	19.3%	19.0%
Government				
Federal Government	311.9	249.1	2.5	1.7
State and Local Government	1,795.1	2,164.8	14.5	14.6
Professional and Business Services	1,667.8	2,147.7	13.4	14.5
Educational and Health Services	1,238.9	1,584.5	10.0	10.7
Manufacturing				
Nondurable goods	635.3	544.8	5.1	3.7
High Technology	488.6	394.9	3.9	2.7
Other Durable Goods	590.9	473.0	4.8	3.9
Leisure and Hospitality	1,181.5	1,474.4	9.5	10.0
Financial Activities	742.3	926.8	6.0	6.3
Construction	498.8	901.8	4.0	6.1
Other Services	430.6	510.7	3.5	3.5
Information	415.9	475.0	3.3	3.2
Natural Resources and Mining	26.1	23.3	0.2	0.2
<b>TOTAL NON-AGRICULTURAL</b>	<b>12,422.0</b>	<b>14,785.2</b>	<b>100%</b>	<b>100%</b>

Source: State of California, Employment Development Department.

The following tables show California's total and per capita income patterns for selected years.

**TABLE 24****Total Personal Income in California 1995-2005<sup>(a)</sup>**

<b>Year</b>	<b>Millions</b>	<b>% Change<sup>(b)</sup></b>	<b>California % of U.S.</b>
1995	\$ 765,806	4.8%	12.4%
1996	810,448	5.8	12.3
1997	860,545	6.2	12.4
1998	936,009	8.8	12.5
1999	999,228	6.8	12.7
2000	1,103,842	10.5	13.0
2001	1,135,304	2.9	12.9
2002	1,147,716	1.1	12.8
2003	1,184,455	3.2	12.8
2004	1,264,422	6.8	12.9
2005	1,332,919	5.4	12.9

(a) Bureau of Economic Analysis ("BEA") estimates as of March 28, 2006.

(b) Change from prior year.

Note: Omits income for government employees overseas.

Source: U.S. Department of Commerce, BEA.

**TABLE 25****Per Capita Personal Income 1995-2005<sup>(a)</sup>**

<b>Year</b>	<b>California</b>	<b>% Change<sup>(b)</sup></b>	<b>United States</b>	<b>% Change<sup>(b)</sup></b>	<b>California % of U.S.</b>
1995	\$24,161	4.1%	\$23,076	4.1%	104.7%
1996	25,312	4.8	24,175	4.8	104.7
1997	26,490	4.7	25,334	4.8	104.6
1998	28,374	7.1	26,883	6.1	105.5
1999	29,828	5.1	27,939	3.9	106.8
2000	32,463	8.8	29,845	6.8	108.8
2001	32,882	1.3	30,574	2.4	107.5
2002	32,803	-0.2	30,810	0.8	106.5
2003	33,406	1.8	31,463	2.1	106.2
2004	35,278	5.6	33,090	5.2	106.6
2005	36,890	4.6	34,495	4.2	106.9

(a) BEA's estimates as of September 26, 2006.

(b) Change from prior year.

Note: Omits income for government employees overseas.

Source: U.S. Department of Commerce, BEA.

The following tables show California's residential and non-residential construction.

**TABLE 26****Residential Construction Authorized by Permits**

<b>Year</b>	<b>Units</b>			<b>Valuation<sup>(a)</sup> (millions)</b>
	<b>Total</b>	<b>Single</b>	<b>Multiple</b>	
1995	85,293	68,689	16,604	\$13,879
1996	94,283	74,923	19,360	15,289
1997	111,716	84,780	26,936	18,752
1998	125,707	94,298	31,409	21,976
1999	140,137	101,711	38,426	25,783
2000	148,540	105,595	42,945	28,142
2001	148,757	106,902	41,855	28,804
2002	167,761	123,865	43,896	33,305
2003	195,682	138,762	56,920	38,968
2004	212,960	151,417	61,543	44,777
2005	208,972	155,322	53,650	47,138

(a) Valuation includes additions and alterations.

Source: Construction Industry Research Board



**TABLE 27**

**Nonresidential Construction  
(Thousands)**

<b>Year</b>	<b>Commercial</b>	<b>Industrial</b>	<b>Other</b>	<b>Additions and Alterations</b>	<b>Total</b>
1995	\$2,308,911	\$ 732,874	\$1,050,693	\$4,062,273	\$ 8,154,751
1996	2,751,925	1,140,574	1,152,443	4,539,219	9,584,161
1997	4,271,378	1,598,428	1,378,220	5,021,792	12,269,818
1998	5,419,251	2,466,530	1,782,337	5,307,901	14,976,019
1999	5,706,719	2,256,166	2,350,213	6,269,194	16,582,292
2000	6,962,031	2,206,169	2,204,754	7,252,004	18,624,958
2001	6,195,368	1,552,047	2,584,321	6,421,551	16,753,287
2002	5,195,348	1,227,754	2,712,681	5,393,329	14,529,112
2003	4,039,561	1,320,222	2,954,039	5,601,117	13,914,939
2004	5,105,541	1,456,283	3,100,982	6,026,567	15,689,373
2005	5,853,351	1,693,373	3,818,100	6,900,709	18,265,533

Source: Construction Industry Research Board

The following table shows changes in California's exports for the period from 1996 through 2005.

**TABLE 28**

**Exports Through California Ports  
(Millions)**

<b>Year</b>	<b>Exports<sup>(a)</sup></b>	<b>% Change<sup>(b)</sup></b>
1995	\$116,825.0	22.2%
1996	124,120.0	6.2
1997	131,142.7	5.7
1998	116,282.4	-11.3
1999	122,092.8	5.0
2000	148,554.6	21.7
2001	127,255.3	-14.3
2002	111,340.1	-12.5
2003	113,550.7	2.0
2004	123,039.2	8.4
2005	129,988.9	5.6

(a) "Free along ship" Value Basis.

(b) Change from prior year.

Source: U.S. Department of Commerce, Bureau of the Census

## LITIGATION

The state is a party to numerous legal proceedings. The following are the most significant pending proceedings, as reported by the Office of the Attorney General. See “LITIGATION” in the main body of the Official Statement.

### **Challenge Seeking Payment to Teachers’ Retirement Board**

In May 2003, the Legislature enacted legislation (Chapter 6, Statutes of 2003–04, First Extraordinary Session, Senate Bill No. 20, “SBX1 20”) that deferred the payment of \$500 million to CalSTRS’s Supplemental Benefit Maintenance Account (“SBMA”). SBX1 20 also establishes an appropriation of an amount not to exceed \$500 million, adjusted by the actual rate of return to funds in the SBMA, in 2006 and every four years thereafter, for the purpose of funding the SBMA. The actual amount of such appropriation, if any, will be determined following a report by the CalSTRS managing board that the funds in the SBMA will be insufficient in any fiscal year before July 1, 2036, to provide certain payments to CalSTRS members, and the certification of the amount of any such appropriation by the state’s Director of Finance. On October 14, 2003, the CalSTRS board and certain CalSTRS members filed a complaint in the Sacramento County Superior Court as *Teachers’ Retirement Board, as Manager of the California State Teachers’ Retirement System, et al. v. Tom Campbell, Director of California Department of Finance, and Steve Westly, California State Controller* (Case No. 03CS01503). This lawsuit seeks, primarily, a writ of mandate compelling the State Controller to transfer funds from the State’s General Fund to the SBMA in an amount equal to the continuing appropriation, as it existed prior to the enactment of SBX1 20 (\$500 million plus interest). It also seeks injunctive and declaratory relief to the same effect. The Superior Court granted Plaintiffs’ motion for summary adjudication. The court declared SBX1 20 unconstitutionally impairs CalSTRS members’ vested contractual rights. The court ordered the issuance of a peremptory writ of mandate commanding the State Controller to transfer \$500 million from the General Fund to the SBMA. The judgment will include an award of interest in an as yet unknown amount at the rate of 7 percent (7%) per annum both pre- and post-judgment. However, because the Legislature has not appropriated funds to pay such interest, the Superior Court cannot, and did not, compel the payment of any pre- or post-judgment interest. The state has appealed the decision, and plaintiffs and the intervening California Retired Teachers’ Association have filed cross-appeals. If intervenors’ cross-appeal is successful, pre-judgment interest will be calculated at the rate of 10% per annum on the \$500 million from July 1, 2003, through September 21, 2005. The post-judgment interest rate remains 7% per annum.

### **Action Seeking Modification of Retirement Formula for State Employees**

A recently filed case entitled *Joseph Myers et al. v. CalPERS et al.* (Alameda Superior Court, Case No. RG06-262495) alleges that Government Code section 21354.1 violates the age discrimination provisions of the Fair Employment and Housing Act. The lawsuit, plead as a class action on behalf of state employees over age 55 who will retire after January 1, 2001, asserts that the statute “discriminates” against older workers because the change in the retirement formulas it implemented gives them a smaller percentage increase in benefits than it provided to younger workers. The complaint seeks injunctive relief and retroactive retirement benefits of an unspecified nature. It is unclear from the complaint what retroactive retirement benefits are being sought, or whether they would be offset by reductions in benefits to younger workers, and thus it is impossible at this time to quantify the magnitude of the fiscal impact; however, it may be in excess of \$250 million. The state’s demurrer to the entire complaint (which is plead as a single cause of action) was sustained with leave to amend. The Court ruled that plaintiffs must state facts from which it can be inferred that the retirement formulas being challenged are not required by state or federal law.

## Tax Refund Cases

Six pending cases challenge the Franchise Tax Board's treatment of proceeds from the investment of cash in short-term financial instruments, and the resulting impact on the apportionment of corporate income to a corporation's California tax obligation. The state has advanced two separate theories to sustain its tax assessments. In *General Motors Corp. v. Franchise Tax Board* the California Supreme Court granted General Motors's petition for review of the appellate court's affirmation of a ruling in favor of the Franchise Tax Board (*General Motors Corp. v. Franchise Tax Board*, Case No. S127086) on one of the theories, and in *Microsoft Corporation v. Franchise Tax Board* it granted review of the appellate court's reversal of a ruling in favor of Microsoft on the same issue but on the other theory (*Microsoft Corporation v. Franchise Tax Board* (Case No. S133343)). The state's tax assessments have been sustained in both of these cases but on different grounds. On February 25, 2005, the Court of Appeal, First Appellate District issued an unpublished opinion in *The Limited Stores, Inc. and Affiliates v. Franchise Tax Board* (Case No. A102915) upholding the judgment entered in favor of the Franchise Tax Board. On June 8, 2005, the California Supreme Court granted review in this case and directed that it be held pending decisions in *Microsoft* and *General Motors*. In *Toys "R" Us, Inc. v. Franchise Tax Board* the Court of Appeal, Third Appellate District (Case No. C045386) sustained the trial court's ruling in favor of the Franchise Tax Board in a decision similar to that in *Microsoft*. That decision, however, rejected the rationale adopted by the Court of Appeal in *General Motors*. The California Supreme Court has granted review but deferred briefing. *Montgomery Ward LLC v. Franchise Tax Board* is pending in the San Diego Superior Court (Case No. 802767), and *Colgate-Palmolive v. Franchise Tax Board* is pending in the Sacramento County Superior Court (Case No. 03AS00707); the *Colgate* matter has been stayed, pending the Supreme Court's decision in *General Motors*. Other taxpayers have raised this same issue in administrative actions. A final decision in favor of any of these plaintiffs could have resulted in tax refunds to similarly situated taxpayers in an amount exceeding \$600 million, with a potential future annual revenue loss of \$85 million. The state is vigorously litigating this issue.

Also in *General Motors Corp v. Franchise Tax Board* (discussed above, Case No. S127086), the California Supreme Court granted the taxpayer's petition for review to determine whether the Franchise Tax Board's practice of allowing tax credits on an entity basis rather than to a unitary business is correct. A decision in favor of the taxpayer could result in the refund of taxes in excess of \$300 million for prior years and an ongoing reduction in tax revenues of approximately \$80 million.

On August 17, 2006, the California Supreme Court filed its decisions in *Microsoft* and *General Motors*. In *Microsoft*, the Court affirmed the judgment in favor of the Franchise Tax Board. The Court concluded that while returned principal from investments in short-term investments financial instruments is a "receipt" for income apportionment purposes, the inclusion of returned principal in the income calculation results in an apportionment percentage that does not fairly reflect Microsoft's business activities in California. The Court therefore upheld Franchise Tax Board's use of an alternative apportionment method under Revenue and Taxation Code § 25137 that excluded returned principal from the calculation. In *General Motors*, the Court affirmed the Court of Appeal decision in favor of the Franchise Tax Board on the research credit issue and affirmed in substantial part the lower courts' decisions on the apportionment issue. As in *Microsoft*, the Court held that returned principal was a receipt, but also held that only the interest portion of proceeds from repurchase transactions could be included in the income apportionment calculation. The Court remanded the case for a determination whether the inclusion of returned principal in the income apportionment calculation was distortive of the taxpayer's business activities in California, as the Court had held in *Microsoft*. Petitions for rehearing have been filed by the Franchise Tax Board to clarify portions of these decisions.

Two pending cases challenge the Franchise Tax Board's LLC fees imposed by Revenue and Taxation Code section 17942. In *Northwest Energetic Services, LLC v. Franchise Tax Board*

(San Francisco Superior CGC-05-437721) plaintiff seeks a refund of fees, interest and penalties paid for 1997-2001, and in *Ventas Finance I, LLC v. Franchise Tax Board* (San Francisco Superior Court 05-440001), plaintiff seeks a refund for 2001-2003. In both cases the plaintiffs allege that section 17942 is unconstitutional on its face and as applied because it discriminates against interstate commerce and violates the Due Process and Equal Protection clauses. In the alternative, the plaintiffs also allege that the Franchise Tax Board misinterprets section 17942 and that section 17942 is an improper exercise of the state's police powers. A final decision in favor of these plaintiffs applied to all taxpayers similarly situated could result in loss of annual revenue in excess of \$400 million and potential refunds exceeding \$1.12 billion. In the *Northwest* case, the trial court entered judgment in favor of the plaintiffs and the Franchise Tax Board has appealed. The trial court tentatively ruled in *Ventas* in favor of the plaintiffs.

Two cases challenge the constitutionality of the state's tax amnesty program: *General Electric Company & Subsidiaries v. Franchise Tax Board* (San Francisco Superior Court, CGC 06-449157, Court of Appeal, First District A115530) and *Garcia v. Franchise Tax Board* (San Francisco Superior Court, CGC 06-456659). In both cases, plaintiffs allege the tax amnesty program's amnesty penalty is unconstitutional. Chapter 226, Statutes of 2004 (SB 1100) created an amnesty program for taxable years beginning before January 1, 2003. Under the program, taxpayers that had not paid or had underpaid an eligible tax could agree to pay the tax and waive their rights to claim refunds thereof. In exchange, certain penalties and fees associated with the unpaid taxes would be waived and no criminal actions would be brought for the taxable years for which amnesty was allowed. SB 1100 also imposed a new penalty equal to 50 percent of accrued interest as of March 31, 2005 on any unpaid tax liabilities ultimately determined to be due for taxable years 2002 and earlier for which amnesty could have been requested. In *General Electric*, no penalty has been assessed because the companies final tax liability for the years has not been determined. General Electric seeks a declaration that the amnesty penalty should not apply to tax liabilities that become final after the amnesty period and that are paid within the statutory payment period, or alternatively, that the amnesty penalty is unconstitutional because it violates due process. On September 15, 2006, General Electric filed a notice of appeal in the First District Court of Appeal following the trial court's sustaining of the Franchise Tax Board's demurrer to the entire complaint without leave to amend. The *Garcia* case was recently filed and the state's responsive pleading is not yet due. In *Garcia*, the penalty has been assessed and paid. The fiscal impact of these cases is unknown at this time and is dependent on court rulings, but is estimated to be in excess of \$300 million.

### **Environmental Matters**

In a federal Environmental Protection Agency ("U.S. EPA") administrative abatement action entitled *In the Matter of: Leviathan Mine, Alpine County, California, Regional Water Quality Control Board, Lahontan Region, State of California* (U.S. EPA Region IX CERCLA Docket No. 00-16(a)), the state, as owner of the Leviathan Mine, is a party through the Lahontan Regional Water Quality Control Board ("Board"). Also a party is ARCO, the successor in interest to the mining company that caused certain pollution of the mine site. The Leviathan Mine site is listed on the U.S. EPA "Superfund" List, and both remediation costs and costs for Natural Resource Damages may be imposed on the state. The alleged bases for the state's liability are the state's ownership of the mine site and the terms of a 1983 settlement agreement with ARCO. The Board has undertaken certain remedial action at the mine site, but the U.S. EPA's decision on the interim and final remedies is pending. ARCO has filed several state law claims against the state with the California Victim Compensation and Government Claims Board (an administrative agency with which certain claims must be filed as a prerequisite to litigation seeking damages against the state which was formerly named the Board of Control. Litigation on these claims has been tolled by agreement among the parties until April 1, 2007. It is possible these matters could result in a potential loss to the state in excess of \$400 million.

In *Carla Clark, et. al. v. City of Santa Rosa, et al.* (Sonoma County Superior Court, Case No. SCV-227896), 32 plaintiffs who own property or live in Santa Rosa brought a toxic tort case alleging that water wells supplying water to their homes were contaminated by carcinogenic chemicals. The state is sued under a mandatory duty theory premised on an alleged violation of Proposition 65 (The Safe Drinking Water and Toxic Enforcement Act of 1986). Plaintiffs claim property damage, a variety of physical and psychological maladies including birth defects, medical monitoring costs and damages for fear of cancer. Plaintiffs claim damages exceeding \$400 million. The jury trial in this case recently ended in a mistrial, and the court reconsidered and granted the state's motion for summary judgment. Once judgment in the state's favor is entered, an appeal by the plaintiff is expected.

### **Energy-Related Matters**

In *People v. ACN Energy, Inc., et al.* (Sacramento County Superior Court, Case No. 01AS05497), the court is considering whether and to what extent compensation is due to market participants which have claimed compensation as a result of the Governor's issuance of executive orders, under the California Emergency Service Act, "commandeering" power purchase arrangements held by Pacific Gas & Electric Company ("PG&E") and Southern California Edison ("SCE"), referred to as "block forward contracts." The California Power Exchange, PG&E and other market participants have filed actions for inverse condemnation, recovery under the Emergency Services Act and other causes of action, which are pending in Sacramento County Superior Court, Judicial Council Coordination Proceeding No. 4203. In an administrative proceeding before the Government Claims Board (which was dismissed on procedural grounds), the California Power Exchange stated claims for "commandeering" the block forward contracts in the amount of approximately \$1 billion. The state contends it is not liable for damages as a result of these orders, nor for compensation for inverse condemnation, and that any damages are offset by payments made by the Department of Water Resources for electricity received under the "commandeered" block forward contracts.

### **Escheated Property Claims**

In three pending cases, plaintiffs claim that the State Controller has an obligation to pay interest on private property that has escheated to the state, and that failure to do so constitutes an unconstitutional taking of private property: *Morris v. Westly* (Los Angeles County Superior Court, Case No. BC310200); *Trust Realty Partners v. Westly* (Sacramento County Superior Court, Case No. 04AS02522); and *Coppoletta v. Westly* (Sacramento County Superior Court (Case No. CGC- 05439933). The *Morris* lawsuit challenges whether the state's custodial use of escheated funds entitles the claimant to constructive interest and/or actual interest that was earned while the property is in the state's custody. The *Morris* case seeks a class action determination, and identifies a purported class that could be interpreted to include all persons or entities whose property has been taken into custody by the state. On behalf of the articulated class, the plaintiff in *Morris* seeks a declaration that failure to pay interest is an unconstitutional taking and, among other things, an injunction restraining the State Controller from pursuing the practices complained of in the complaint. The trial court in *Morris* has granted the Controller's motion for summary judgment; and ordered judgment be entered in favor of the state. An appeal by plaintiff is likely. The *Trust Realty Partners* lawsuit focuses on the state's elimination of interest payments on unclaimed property claims (Code of Civil Procedure Section 1540, subdivision ©, as amended effective August 11, 2003, "CCP 1540"). The *Trust Realty Partners* case is not styled as class action suit, but in addition to seeking general and special damages in a sum according to proof at trial, the case seeks a common fund recovery and an injunction restraining the State Controller from engaging in the acts alleged in the complaint. In May 2006, the trial court granted an interim order on a motion for summary adjudication ordering the state to pay interest on certain pending claims made before the amendment to CCP 1540. The Controller is challenging this order. The *Coppoletta* case raises issues analogous to those in *Morris* and also asks that the unclaimed property law be construed as creating a

trust for the benefit of the true owner. In May 2006, the San Francisco Superior Court entered an order granting the state's motion for summary judgment (dismissing the case) in *Coppoletta*. Plaintiffs are seeking relief from the trial court's decision. On May 10, 2006, the *Coppoletta* plaintiffs filed *Coppoletta v. Westly* (Case No. C 06 3135 WHA) in the United States District Court for the Eastern District of California, and on September 15, 2006, the court granted the state's motion to dismiss. The claims in the later filed federal case were identical to those in the state court case as to which judgment was granted in the San Francisco Superior Court. It is the state's position that the claims in the federal case are barred. If the *Morris* case ultimately prevails as a class action, or the injunctions prayed for in the *Trust Realty Partners* cases are issued and upheld, or if the issues raised in any of these cases require the State Controller to pay interest on escheated property or to manage unclaimed property as a trust for the benefit of the true owners, as the plaintiffs allege is required by law, costs to the state could be in excess of \$500 million.

### **Actions Seeking Damages for Alleged Violations of Privacy Rights**

In *Gail Marie Harrington-Wisely, et al. v. State of California, et al.* (Los Angeles County Superior Court, Case No. BC 227373), a proposed class action, plaintiffs seek damages for alleged violations of prison visitors' rights resulting from the Department of Corrections and Rehabilitation's use of a body imaging machine to search visitors entering state prisons for contraband. This matter has been certified as a class action. The superior court granted final judgment in favor of the state. Plaintiffs are expected to appeal. If a court were to revive the damages claims and award damages pursuant to the California Civil Code for every use of the body-imaging machine, damages could be as high as \$3 billion.

A pending case involves due process constitutional challenges to an individual being placed on the state's child abuse central index prior to the conclusion of a noticed hearing: *Gomez v. Saenz, et al.* (Los Angeles County Superior Court, Case No. BC 284896). In another case, the California appellate court held that before a person is placed on the child abuse central index, that person is entitled to a hearing. However, the appellate court did not decide the issue of what type of hearing would be sufficient. That issue is the subject of the current activity at the trial court in *Gomez*. Depending on the type and scope of the hearing that the trial court might order, and the number of individuals currently on the index that might be entitled to a hearing prior to remaining on the index, the costs to the state related to conducting these hearings could be in excess of \$500 million.

The plaintiff in *Gilbert P. Hyatt v. FTB* (State of Nevada, Clark County District Court, A382999) was subject to an audit by the Franchise Tax Board involving a claimed change of residence from California to Nevada. Plaintiff filed a tort action in the State of Nevada alleging a number of separate torts involving privacy rights and interference with his business relationships arising from the Franchise Tax Board's audit. A Nevada jury trial was scheduled, but the trial judge ordered a stay of the trial pending the Nevada Supreme Court's consideration on a writ filed by Hyatt asking for review of the trial court's ruling that Hyatt had not established a causal relation between the FTB's audit and the loss of his licensing business with Japanese companies. It is unknown when a decision will be made as to whether a hearing will be granted. The economic damages claim exceeds \$500 million. The state is vigorously contesting this matter.

### **Action Seeking a Cost of Living Adjustment for CalWORKs Recipients**

The case of *Juana Raquel Guillen, et al. v. Schwarzenegger, et al.* is currently pending before the Court of Appeal (First Appellate District, Division 3; Case No. A106873). The trial court decision on appeal in this case determined that Governor Schwarzenegger's executive order in November 2003, which reduced the Vehicle License Fee charged to vehicle owners and increased the corresponding Vehicle License Fee offset to local governments (See "STATE FINANCES—Local Governments—

Vehicle License Fee”), acted as an “increase in tax relief”, which, by statute, triggers an upward cost of living adjustment for recipients of CalWORKs program benefits. The petitioners seek a cost of living adjustment, beginning with fiscal year 2003–04. The cost to the state of a final, unappealable determination consistent with the determination of the trial court, is estimated to be in excess of \$360 million.

### **Actions Seeking Program Modifications**

In the following cases, plaintiffs seek court orders or judgments that would require the state to modify existing programs and, except as specified, do not seek monetary damages. Nevertheless, a judgment against the state in any one of these cases could require changes in the challenged program that could result in increased programmatic costs to the state in a future fiscal year in excess of \$250 million. Alternatively, in some circumstances, it may be possible that a judgment against the state could be addressed by legislative changes to the program that would cost less.

The matter of *Conlan v. Bonta* (First Appellate District, Case No. A106278) followed a prior appellate court decision determining that the state’s Medi-Cal program violates federal law because the program fails to promptly reimburse medical payments made by patients within the 90-day window prior to submitting an application for Medi-Cal benefits. The state’s Medi-Cal program relies on Medi-Cal providers to reimburse beneficiaries for out-of-pocket expenses paid during this retroactive “reimbursement window” period. On remand following this appellate decision, the trial court ordered the Department of Health Services to develop a compliance plan to implement the appellate decision. Since that time the matter has gone back and forth to the appellate court for further direction. The Department of Health Services is continuing to take steps to implement the appellate court’s decisions. Following a further hearing, the court ordered the state to expand the scope of costs for which the state must make reimbursements to include out-of-pocket monies actually paid by a beneficiary to Medi-Cal providers for erroneously collected costs on covered services (at Medi-Cal rates) incurred after issuance of a beneficiary’s Medi-Cal card. While the impact of the cost of complying with the trial court’s plan for reimbursement is unknown, certain estimates of the costs of the administrative due process procedures required by the court, when combined with the cost of reimbursements that the Department of Health Services now believes may not be eligible for federal off-set, and the costs of reimbursing out-of-pocket fees erroneously collected by Medi-Cal providers, may be in excess of \$250 million.

The following case seeks reforms to state programs for the treatment of institutionalized disabled persons. Some rough estimates suggest the financial impact of a judgment against the state defendants could be as high as \$1 billion per year in programmatic costs going forward. The state is vigorously defending this action.

In *Capitol People First v. Department of Developmental Services* (Alameda County Superior Court, Case No. 2002-038715) a consortium of state and national law firms and public-interest groups brought suit against the Department of Finance, California Department of Developmental Services and California Department of Health Services, alleging violations of the Lanterman Act, the ADA, and section 504 of the Rehabilitation Act by defendants needlessly isolating thousands of people with developmental disabilities in large facilities. The case seeks sweeping reforms, including requiring the state to offer a full range of community-based services.

### **Actions Seeking Medi-Cal Reimbursements**

Two cases, each entitled *California Association of Health Facilities (“CAHF”) v. Department of Health Services (“DHS”)* have been consolidated in the First District Court of Appeal (Case Nos. 03-425819 and 02-415443). CAHF, which represents approximately 1400 skilled-nursing and

intermediate-care facilities, filed two separate cases alleging that the Medi-Cal reimbursement rates paid by DHS to providers for, respectively, the 2001-2002 and 2002-2003 rate years were too low. The superior court sustained DHS's demurrers in both cases and entered judgment for DHS. CAHF'S appeal has been fully briefed and the parties are awaiting notification of a date for oral argument. A final decision adverse to DHS in both of the consolidated cases could result in reimbursement costs exceeding \$250 million.

### **Actions to Increase Amount of State Aid for Foster or Adopted Developmentally Disabled Dependent Children**

Ten pending class action lawsuits challenge the amount of aid provided by the state for the care of dependent children (either in foster care or adopted) who have also been determined to be developmentally disabled by a regional center. These cases have been coordinated in *Butler v. Department of Social Services* (Los Angeles Superior Court, Case No. BC329695). Specifically, plaintiffs assert that they were entitled to, but did not receive, the Alternative Residential Model (ARM) rate (also known as dual agency rate) but have instead been receiving the standard AFDC-FC (foster care) rate and/or the AAP (adoption assistance program) rate. A final decision in favor of these plaintiffs could exceed \$450 million. The state is vigorously litigating this issue.

In a statewide class action against DHS, Department of Social Services and Los Angeles (*Katie A., et al. v. Bonta, et al., U.S. District Court*, Case No. CV 02-05662 AHM (SHx) plaintiffs seek to expand Medicaid-covered services under the Early and Periodic Screening, Diagnosis and Treatment program for mentally disordered children in foster care to include what plaintiffs call "wraparound services," "therapeutic foster care," and "comprehensive case management services in a home-like setting." Plaintiffs allege that the ADA, the Medicaid Act, the Rehabilitation Act, substantive due process, and Government Code section 11135 require these services. Recently, the federal district court issued a preliminary injunction against the state defendants and ordered the state defendants to provide "wraparound services" and "therapeutic foster care" to class members within 120 days. Further, the court ordered the state defendants and plaintiffs to meet and confer both to develop a plan to implement the preliminary injunction and to come to consensus on whether the court should appoint a special master. At this time, it is unknown what financial impact such an unprecedented decision would have on the state's General Fund.

### **Local Government Mandate Claims and Actions**

In a test claim filed by the County of San Bernardino, now pending before the Commission on State Mandates (the "Commission") (Medically Indigent Adults, 01-TC-26 County of San Bernardino, Claimant, Statutes 1982, Chapters 328 and 1594), the Commission is being asked to determine the costs incurred by the county to provide state-mandated care of medically indigent adults ("MIAs"). The amount demanded in the claim for un-reimbursed costs for fiscal year 2000-2001 is just over \$9.2 million. The County of San Bernardino's test claim poses a potential for a negative impact on the General Fund in the amount of the un-reimbursed costs for all similarly situated county claimants for a period of years, as determined by the Commission. Certain estimates of the annual cost of the services rendered by all counties to MIAs exceed \$4 billion. How much of that will be determined to be "un-reimbursed" to the counties by the state is unknown. In recent years, the counties have received approximately \$1 billion annually in vehicle license fee revenue and \$410 million annually in sales tax revenue to fund various public health programs, which include the programs that provide services to MIAs. The state law that authorized the transfer of the vehicle license fee portion of this revenue to the counties and the authority to transfer the revenue to the counties were automatically repealed as a result of a provision of State law, which was triggered as a result of a final decision (*County of San Diego v. Commission on State Mandates, et al.* (1997) 15 Cal. App. 4th 68; petition for review denied by the California Supreme Court)



that awarded the County of San Diego un-reimbursed costs for medical services rendered to MIAs. Various regulatory and statutory steps have been and are being taken to address this reduction in revenues.

Two lawsuits are pending in which Orange and San Diego counties claim they are entitled to full and immediate reimbursement of all mandated costs for which the state has not provided full reimbursement. These lawsuits were consolidated in San Diego County Superior Court (*County of San Diego v. State of California, et al.* (Case No. GIC 825109) and *County of Orange v. State of California, et al.* (Case No. GIC 827845)). These plaintiff counties are seeking relief that would divert current budget appropriations away from various state agencies, and to the counties, as full payment for the un-reimbursed costs of implementing a variety of state mandated programs over the last ten years. The County of San Diego has alleged un-reimbursed costs in excess of \$40 million through fiscal year 2003–04 for a variety of programs. The County of Orange has alleged in excess of \$116 million for un-reimbursed state-mandated costs. The effects of a final determination by an appellate court that the state is required to reimburse the counties now in an amount equal to the previously unreimbursed state mandated costs, if applied to each of California’s 58 counties, could result in costs in excess of \$1.5 billion for existing un-reimbursed mandates.

Following a trial, the court entered a declaratory judgment in favor of the counties regarding the amounts owed, and issued a writ of mandate commanding the state to comply with Government Code section 17617 by making equal annual payments to the counties over the 15-year term currently prescribed by statute, or a shorter period should the statute be amended. Final judgment has been entered. The state defendants have appealed, and the counties have cross-appealed.

In January 1987 the Commission determined that a new statutory requirement for completion of a second science course for graduation from high school imposed reimbursable state-mandated costs on school districts. The State Controller reduced claims for teachers’ salaries attributed to the additional science course requirement on the ground that districts were presumed to have laid off non-science teachers to offset any increase in science teachers. On appeal by many school districts the Commission upheld the State Controller’s position. In early 2005 the Superior Court for the County of Sacramento issued a judgment (which is now final) in consolidated cases lead by *San Diego Unified School District, et al., v. Commission on State Mandates, et al.* (Sacramento Superior Court, Case No. 03CS01401) and *Woodland Joint Unified School District v. Commission on State Mandates, et al.* (Sacramento Superior Court, Case No. 05CS01401) finding the Controller’s practice was not authorized by law and ordering the Commission to review a re-evaluation of the claims by the Controller. The Commission has determined that the school districts’ claims for extra science teachers’ salaries must be paid in full. It is possible that these claims would add hundreds of millions of dollars to existing state funding responsibility for K-12 education.

### **Actions Seeking to Enjoin Implementation of or Cause Amendment to Certain Tribal Gaming Compacts**

In June 2004, the state entered into amendments to tribal gaming compacts (the “Amended Compacts”) between the state and five Indian Tribes (the “Five Tribes”). Those Amended Compacts are being challenged as described below. An unfavorable decision to the state in either of the cases described below (or in any future litigation relating to the Amended Compacts) could eliminate future receipts of gaming revenues anticipated to result from the Amended Compacts, and could delay or impair the state’s ability to sell a portion of the revenue stream anticipated to be generated by these Amended Compacts. The state anticipates using the proceeds of that sale to repay existing internal borrowings of transportation funds. See “CURRENT STATE BUDGET—2006 Budget Act– Transportation Funding.”

In *Rincon Band of Luiseno Mission Indians of the Rincon Reservation v. Schwarzenegger, et al.* (U.S. District Court, Case No. 04 CV 1151 W (WMc)) the plaintiff (the “Rincon Band”), a federally recognized Indian Tribe, alleges, in primary part, that a compact entered into between the Rincon Band and the state in 1999, is part of a statewide regulatory framework that limits gaming devices and licenses on non-Indian lands for the stated goal of promoting tribal economic development. The plaintiff further alleges that the Amended Compacts would materially alter these protections, and as such, would constitute an unconstitutional impairment of the Rincon Band’s 1999 compact. The complaint filed by the Rincon Band seeks, among other things, an injunction against the implementation of the Amended Compacts. It also raises other breach of compact claims. The District Court denied plaintiff’s motion for injunctive relief, and dismissed the complaint on a procedural basis as to the impairment claims and on lack of jurisdiction as to the breach of compact claims. The District Court granted plaintiff’s request for re-consideration in part, but dismissed all but four claims that the state failed to negotiate a compact amendment with the Rincon Band in good faith. The injunctive relief denied by the court remains subject to appeal. The state filed a motion for certification and entry of a separate judgment with respect to the four claims that the District Court ordered dismissed including the impairment of compact claims. The District Court granted the state’s motion and entered final judgment from which the Rincon Band filed notice of appeal (U.S. Court of Appeals, Ninth Circuit, Case No. 06-055259). The Rincon Band filed its opening brief in June 2006. In that brief, the Rincon Band abandoned its appeal of the claims for relief challenging the validity of the Amended Compacts. However, one of the issues remaining in the appeal involves the total number of gaming device licenses authorized under the 1999 Compacts. In July 2006, the state filed its answering brief, explaining that resolution of the license issue could adversely affect the tribes with the Amended Compacts. Also, in July 2006, the Five Tribes filed an amicus brief raising the same point – making it clear that they were necessary and indispensable parties whose ability to carry out their obligations under the Amended Compacts could be affected. On August 14, 2006, the Rincon Band filed its reply brief.

*California Commerce Casino, Inc., et al. v. Schwarzenegger, et al.* (Los Angeles Superior Court, Case No. BS097163) is an action brought by the owner of a card room and an individual plaintiff and petitioner, challenging the Legislature’s ratification of the Amended Compacts, which was done through urgency legislation (Statutes 2004, Chapter 91; “Chapter 91”). Plaintiffs and petitioners allege that Chapter 91 violates a provision of the California Constitution, which bars the grant of vested rights or franchises in an urgency measure, and allege a variety of special privileges and vested rights and interests purportedly created by Chapter 91. The complaint also alleges that Chapter 91 violates provisions of the California Constitution which prohibit certain borrowings to fund a year - end state budget deficit; and constitutes an unconstitutional attempt to contract away the state’s police power. Plaintiffs and petitioners seek an injunction restraining the implementation of Chapter 91, a decision prohibiting the implementation of Chapter 91, and a declaration that Chapter 91 is unconstitutional. Defendants filed a demurrer to the complaint, which was granted, without leave to amend, on October 25, 2005. In granting the demurrer, the court found that: (1) all nine claims were barred by the 60 day statute of limitations in Chapter 91 and (2) the plaintiffs failed and, because of sovereign immunity, were not able to name the five affected tribes as necessary and indispensable parties. The court dismissed the case with prejudice; and plaintiffs have appealed this decision. Appellate argument occurred on October 18, 2006, and the matter has been submitted. (Court of Appeal, Second Appellate District, Case No. B188220).

*Hollywood Park Land Co., et al. v. Golden State Transportation, et al.* (Sacramento Superior Court, Case No. 06AS00166) is a reverse validation action brought by various horse racetrack interests, challenging validity of the proposed issuance of tribal gaming bonds. The plaintiffs’ legal theories and complaint are virtually identical to the legal theories and complaint in *California Commerce Casino, Inc., et al. v. Schwarzenegger, et al.* described in the paragraph above (“*Commerce Casino*”). Specifically, this case claims that the bonds and bond documents would (1) result in unconstitutional contracting away of the state’s police power to regulate gaming; and (2) trigger an unconstitutional grant of a franchise,

special privilege and/or vested right contained in the Amended Compacts. In addition, plaintiffs allege Chapter 91, and the use of bond proceeds as described therein, would violate Proposition 58. Plaintiffs have sought injunctive relief. The *Commerce Casino* plaintiffs filed a notice of appearance in this case contesting the validity of the bonds and bond documents. In addition, the Gabrielino-Tongva Tribe and a tribal councilman, filed a notice of appearance and written response contesting the validity of the bonds and the bond contracts. Additionally, they seek to have the tribal-state exclusivity provisions of the Amended Compacts declared invalid and void and a declaration that CCP Section 1811 is unconstitutional as violating the due process rights of the tribe and its members.

A recently filed case entitled *San Pasqual Band of Mission Indians v. State of California, et al.* (U.S. District Court, Case No. 06 CV 0988) asserts that the slot machine licenses that the five Indian Tribes to the Amended Compacts (the “Five Tribes”) were required to keep in operation as a condition of being allowed access to additional slot machines are available for issuance through the license draw process provided for in the 1999 compacts. The complaint seeks declaratory relief and an order requiring the licenses of the Five Tribes be redistributed or made available to other tribes. Should relief be granted, and the state be ordered to redistribute the licenses, the authority of the Five Tribes to continue to operate the slot machines currently covered by those licenses would be rendered uncertain under the Amended Compacts, which do not contemplate the Five Tribes losing their licenses to operate those machines. The loss of these licenses would thus present questions about the monetary obligations of the Five Tribes that would presumably be required to be addressed by amendment of the Amended Compacts.

### **Matter Seeking Validation of Pension Obligation Bonds**

The Legislature enacted the California Pension Restructuring Bond Act of 2004 (Government Code sections 16940 et seq.), which authorized the Pension Obligation Bond Committee (the “Committee”) to issue bonds to fund all or a portion of the state’s pension obligation in any two fiscal years. Pursuant to that authorization, the Committee authorized the issuance of bonds in an amount not to exceed \$960 million to pay a portion of the state’s pension obligation for fiscal year 2004–05. The Committee also resolved to seek court validation of the bonds and the indenture pertaining to the bonds pursuant to a validation process established by Code of Civil Procedure Sections 860 et seq. The Committee filed *Pension Obligation Bond Committee v. All Persons Interested in the Matter of the Validity of the State of California’s Pension Obligation, etc.* (Sacramento County Superior Court, Case No. 04AS04303). The trial court found that the bonds were not valid under the state’s debt limit. The Committee has appealed and briefing is underway (Court of Appeal, Third Appellate District, Case No. C051749). The state will not be able to issue pension obligation bonds until this matter is finally resolved.

### **Prison Healthcare Reform**

*Plata v. Schwarzenegger* (U.S. District Court case no. C-01-1351 THE) is a class action regarding all prison medical care in the state. Plaintiffs alleged that the state was not providing constitutionally adequate medical care as required by the Eighth Amendment to the U.S. Constitution. The case was settled in 2002, but the federal court retained jurisdiction to enforce the terms of a stipulated judgment. The judgment set up a team of experts to evaluate the adequacy of the medical care delivery system and propose solutions to fulfill the state’s obligations to plaintiffs under the Eighth Amendment to the U.S. Constitution. On June 30, 2005, the district court ruled from the bench that he would appoint a receiver to run and operate the approximately \$750 million adult health care delivery system (excluding mental health and dental care) of the California Department of Corrections and Rehabilitation (“CDCR”), affecting approximately 32 prisons throughout the state (excluding Pelican Bay State Prison). On October 3, 2005, the district court issued two orders: (1) Findings of Fact and Conclusions of Law Re: Appointment of Receiver; and (2) Order Appointing Court Expert to “assist the Court in identifying discrete, urgently needed, remedial measures,” including providing clinical staff at those institutions with

the greatest immediate need, pending the appointment of a receiver. The Court appointed a receiver in February 2006, who began his official duties in mid-April 2006. The Receiver is continuing his “90-day San Quentin Project,” to address the health care situation at the prison, including discussion to build a new medical complex at the prison. CDCR continues to work with the Receiver’s staff on changing CDCR’s contracting and procurement processes, with the Receiver bringing in a consulting firm to address the management structure of the CDCR health care contracting processes, and contracting with Unisys to provide a contract management information technology system. The Receiver will also be contracting out pharmacy management. Additionally, the Court recently granted the Receiver’s request for relief to waive state law to raise health care salaries. The Receiver is also in the preliminary stages of discussion regarding building 5000 medical beds. At this time, it is unknown what financial impact such an unprecedented decision would have on the state’s General Fund.

### **Action Seeking Recalculation of Proposition 98 Minimum Funding Guarantee**

On August 8, 2005, a lawsuit titled *California Teachers Association et al v. Arnold Schwarzenegger et al.* (Sacramento County Superior Court, Case No. 05CS01165) was filed. Plaintiffs - California Teachers Association, California Superintendent of Public Instruction Jack O’Connell, and various other individuals - allege that the California Constitution’s minimum school requirement was not met in fiscal years 2004-05 and 2005-06. Plaintiffs allege an underfunding of approximately \$3.1 billion for the two fiscal years. Plaintiffs seek a writ of mandate requiring the state to recalculate the minimum-funding guarantee in compliance with Article XVI, Section 8 of the California Constitution and declaratory relief finding that the state failed to appropriate sufficient funds to comply with the minimum funding requirement. On May 10, 2006, counsel for all parties executed a settlement agreement. On May 15, 2006 the court issued an order staying the action pending implementation of the agreement by the passage of implementing legislation by the Legislature.

The settlement calls for the payment of the outstanding balance of the minimum funding obligation to school districts and community college districts, approximately \$3 billion, as follows: \$300 million in fiscal year 2007-2008, and \$450 million in fiscal year 2008-2009 and each year thereafter, until the entire minimum funding obligation has been paid. The final payment is expected to occur in approximately 2013-2014. The Legislature approved and the Governor has signed bill (SB 1133) providing for the \$300 million appropriation due in Fiscal Year 2007-2008 in partial payment of the settlement. On September 29, 2006, the bill was chaptered (Stats, 2006, ch. 751).

### **STATE DEBT TABLES**

The tables which follow provide information on outstanding state debt, authorized but unissued general obligation bonds and commercial paper notes, debt service requirements for state general obligation and lease-purchase bonds, and authorized and outstanding state revenue bonds. For purposes of these tables, “General Fund bonds,” also known as “non-self liquidating bonds,” are general obligation bonds expected to be paid from the General Fund without reimbursement from any other fund. Although the principal of general obligation commercial paper notes in the “non-self liquidating” category is legally payable from the General Fund, the state expects that principal of such commercial paper notes will be paid only from the issuance of new commercial paper notes or the issuance of long-term general obligation bonds to retire the commercial paper notes. Interest on “non-self liquidating” general obligation commercial paper notes is payable from the General Fund.

“Enterprise Fund bonds,” also known as “self liquidating bonds,” are general obligation bonds for which program revenues are expected to be sufficient to reimburse in full the General Fund for debt service payments, but any failure to make such a reimbursement does not affect the obligation of the state to pay principal and interest on the bonds from the General Fund.

“Special Revenue Fund bonds” also known as “Economic Recovery Bonds,” are “self liquidating” general obligation bonds which are primarily secured by a pledge of a one-quarter cent statewide sales and use tax deposited in the Fiscal Recovery Fund. Debt service payments are made directly from the Fiscal Recovery Fund and not the General Fund. The Special Revenue Fund bonds are also general obligations of the state to which the full faith and credit of the state are pledged to the punctual payment of the principal of and interest thereon.

As of November 8, 2006, the state had \$1,119,785,000 of outstanding commercial paper notes. The following tables do not reflect \$79,870,000 State Public Works Board of the State of California Lease Revenue Bonds, 2006 Series E, issued on October 12, 2006 and \$300,205,000 combined principal amount of State Public Works Board of the State of California Refunding Revenue Bonds, 2006 Series A and 2006 Series F issued on November 8, 2006.

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# AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS

As of October 1, 2006

(Thousands)

	Voter Authorization Date	Voter Authorization Amount	Bonds Outstanding (a)	CP Program Authorized (b)	Unissued (c)
<b>GENERAL FUND BONDS (Non-Self Liquidating)</b>					
1988 School Facilities Bond Act	11/08/88	800,000	319,150	2,255	0
1990 School Facilities Bond Act	06/05/90	800,000	342,630	2,125	0
1992 School Facilities Bond Act	11/03/92	900,000	493,277	3,789	0
California Clean Water, Clean Air, Safe Neighborhood Parks, and Coastal Protection Act of 2002	03/05/02	2,600,000	611,515	908,060	1,073,410
California Library Construction and Renovation Bond Act of 1988	11/08/88	75,000	37,460	0	2,595
California Park and Recreational Facilities Act of 1984	06/05/84	370,000	71,855	N/A	1,100
California Parklands Act of 1980	11/04/80	285,000	12,675	N/A	0
California Reading and Literacy Improvement and Public Library Construction and Renovation Bond Act of 2000	03/07/00	350,000	94,005	178,170	64,970
California Safe Drinking Water Bond Law of 1976	06/08/76	175,000	22,950	N/A	2,500
California Safe Drinking Water Bond Law of 1984	11/06/84	75,000	14,755	N/A	0
California Safe Drinking Water Bond Law of 1986	11/04/86	100,000	47,005	N/A	0
California Safe Drinking Water Bond Law of 1988	11/08/88	75,000	42,630	6,960	0
California Wildlife, Coastal, and Park Land Conservation Act	06/07/88	776,000	301,270	N/A	7,330
Children's Hospital Bond Act of 2004	11/02/04	750,000	71,995	516,576	161,430
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998 (Higher Education)	11/03/98	2,500,000	2,274,610	113,670	0
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998 (K-12)	11/03/98	6,700,000	5,943,505	11,860	0
Clean Air and Transportation Improvement Bond Act of 1990	06/05/90	1,990,000	1,197,965	191,785	15,630
Clean Water Bond Law of 1970	11/03/70	250,000	2,500	N/A	0
Clean Water Bond Law of 1974	06/04/74	250,000	5,075	N/A	0
Clean Water Bond Law of 1984	11/06/84	325,000	49,890	N/A	0
Clean Water and Water Conservation Bond Law of 1978	06/06/78	375,000	14,370	N/A	0
Clean Water and Water Reclamation Bond Law of 1988	11/08/88	65,000	39,880	0	0
Community Parklands Act of 1986	06/03/86	100,000	25,480	N/A	0
County Correctional Facility Capital Expenditure Bond Act of 1986	06/03/86	495,000	135,050	N/A	0
County Correctional Facility Capital Expenditure and Youth Facility Bond Act of 1988	11/08/88	500,000	242,050	0	0
County Jail Capital Expenditure Bond Act of 1981	11/02/82	280,000	18,900	N/A	0
County Jail Capital Expenditure Bond Act of 1984	06/05/84	250,000	13,500	N/A	0
Earthquake Safety and Public Buildings Rehabilitation Bond Act of 1990	06/05/90	300,000	210,010	28,300	0

# AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS

As of October 1, 2006

(Thousands)

	Voter Authorization Date	Voter Amount	Bonds Outstanding (a)	CP Program Authorized (b)	Unissued (c)
<b>GENERAL FUND BONDS (Non-Self Liquidating)</b>					
Fish and Wildlife Habitat Enhancement Act of 1984	06/05/84	85,000	16,860	N/A	0
Hazardous Substance Cleanup Bond Act of 1984	11/06/84	100,000	0	N/A	0
Higher Education Facilities Bond Act of 1986	11/04/86	400,000	66,000	N/A	0
Higher Education Facilities Bond Act of 1988	11/08/88	600,000	226,080	0	10,440
Higher Education Facilities Bond Act of June 1990	06/05/90	450,000	198,840	980	1,130
Higher Education Facilities Bond Act of June 1992	06/02/92	900,000	567,100	0	7,235
Housing and Emergency Shelter Trust Fund Act of 2002	11/05/02	2,100,000	28,790	1,200,000	871,125
Housing and Homeless Bond Act of 1990	06/05/90	150,000	5,155	N/A	0
Kindergarten-University Public Education Facilities Bond Act of 2002 (Higher Education)	11/05/02	1,650,000	784,345	851,490	0
Kindergarten-University Public Education Facilities Bond Act of 2002 (K-12)	11/05/02	11,400,000	9,325,625	1,955,980	0
Kindergarten-University Public Education Facilities Bond Act of 2004 (Hi-Ed)	03/02/04	2,300,000	124,265	1,622,710	552,630
Kindergarten-University Public Education Facilities Bond Act of 2004 (K-12)	03/02/04	10,000,000	2,711,070	7,277,005	0
Lake Tahoe Acquisitions Bond Act	08/02/82	85,000	13,425	N/A	0
New Prison Construction Bond Act of 1981	06/08/82	495,000	0	N/A	0
New Prison Construction Bond Act of 1984	06/05/84	300,000	0	N/A	0
New Prison Construction Bond Act of 1986	11/04/86	500,000	96,440	N/A	0
New Prison Construction Bond Act of 1988	11/08/88	817,000	315,850	7,190	0
New Prison Construction Bond Act of 1990	06/05/90	450,000	175,360	2,057	298
Passenger Rail and Clean Air Bond Act of 1990	06/05/90	1,000,000	448,780	0	0
Public Education Facilities Bond Act of 1996 (Higher Education)	03/26/96	975,000	794,990	0	37,465
Public Education Facilities Bond Act of 1996 (K-12)	03/26/96	2,025,000	1,531,665	12,965	0
Safe Drinking Water, Clean Water, Watershed Protection, and Flood Protection Act	03/07/00	1,970,000	798,835	593,514	487,949
Safe Neighborhood Parks, Clean Water, Clean Air, and Coastal Protection Bond Act of 2000	03/07/00	2,100,000	1,265,045	456,725	309,690
Safe, Clean, Reliable Water Supply Act	11/05/96	995,000	661,195	269,310	0
School Building and Earthquake Bond Act of 1974	11/05/74	40,000	26,650	N/A	0
School Facilities Bond Act of 1988	06/07/88	800,000	268,795	N/A	0
School Facilities Bond Act of 1990	11/06/90	800,000	389,620	0	0
School Facilities Bond Act of 1992	06/02/92	1,900,000	1,015,675	12,555	0
Seismic Retrofit Bond Act of 1996	03/26/96	2,000,000	1,596,135	143,560	0

# AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS

As of October 1, 2006

(Thousands)

	Voter Authorization Date	Voter Amount	Bonds Outstanding (a)	CP Program Authorized (b)	Unissued (c)
<b>GENERAL FUND BONDS (Non-Self Liquidating)</b>					
Senior Center Bond Act of 1984	11/06/84	50,000	0	N/A	0
State Beach, Park, Recreational and Historical Facilities Bond Act of 1974	06/04/74	250,000	0	N/A	0
State School Building Lease-Purchase Bond Law of 1982	11/02/82	500,000	0	N/A	0
State School Building Lease-Purchase Bond Law of 1984	11/06/84	450,000	35,000	N/A	0
State School Building Lease-Purchase Bond Law of 1986	11/04/86	800,000	146,800	N/A	0
State, Urban, and Coastal Park Bond Act of 1976	11/02/76	280,000	9,525	N/A	0
Stem Cell Research and Cures Bond Act of 2004	11/02/04	3,000,000	0	200,000	2,800,000
Veterans Homes Bond Act of 2000	03/07/00	50,000	3,080	31,750	15,170
Voting Modernization Bond Act of 2002	03/05/02	200,000	36,100	0	137,370
Water Conservation Bond Law of 1988	11/08/88	60,000	36,295	8,855	0
Water Conservation and Water Quality Bond Law of 1986	06/03/86	150,000	54,960	N/A	27,600
Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002	11/05/02	3,440,000	785,190	1,012,347	1,628,498
<b>Total General Fund Bonds</b>		<u>79,128,000</u>	<u>37,215,497</u>	<u>17,622,542</u>	<u>8,215,564</u>
<b>ENTERPRISE FUND BONDS (Self Liquidating)</b>					
California Water Resources Development Bond Act	11/08/60	1,750,000	667,415	N/A	167,600
Veterans Bond Act of 1980	06/03/80	750,000	37,500	0	0
Veterans Bond Act of 1982	11/02/82	450,000	73,500	0	0
Veterans Bond Act of 1984	11/06/84	650,000	168,020	0	0
Veterans Bond Act of 1986	06/03/86	850,000	262,115	0	0
Veterans Bond Act of 1988	06/07/88	510,000	233,970	N/A	0
Veterans Bond Act of 1990	11/06/90	400,000	181,340	N/A	0
Veterans Bond Act of 1996	11/05/96	400,000	268,995	0	0
Veterans Bond Act of 2000	11/07/00	500,000	14,415	485,585	0
<b>Total Enterprise Fund Bonds</b>		<u>6,260,000</u>	<u>1,907,270</u>	<u>485,585</u>	<u>167,600</u>



# AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS

As of October 1, 2006

(Thousands)

	Voter Authorization Date	Voter Authorization Amount	Bonds Outstanding (a)	CP Program Authorized (b)	Unissued (c)
<b>SPECIAL REVENUE FUND BONDS (Self Liquidating)</b>					
Economic Recovery Bond Act	04/10/04	15,000,000	9,759,490	N/A	3,746,000
<b>Total Special Revenue Fund Bonds</b>		15,000,000	9,759,490	0	3,746,000
<b>TOTAL GENERAL OBLIGATION BONDS</b>		100,388,000	48,882,257	18,108,127	12,129,164

(a) Includes the initial value of capital appreciation bonds rather than the accreted value.

(b) Represents the total amount of commercial paper authorized by Finance Committees that could be issued for new money projects. Of this amount, no more than \$1.5 billion of commercial paper principal and interest can be owing at any time. Currently, there is \$703,285,000.00 of commercial paper issued and outstanding. The bond acts marked as "n.a." are not legally permitted to utilize commercial paper, or all bonds were issued before the commercial paper program began.

(c) Treats full commercial paper authorization as issued; see footnote(b).

SOURCE: State of California, Office of the Treasurer.

**OUTSTANDING STATE DEBT**  
**FISCAL YEARS 2001-02 THROUGH 2005-06**  
**(Dollars in Thousands Except for Per Capita Information)**

	<u>2001-02</u>	<u>2002-03</u>	<u>2003-04</u>	<u>2004-05</u>	<u>2005-06</u>
<b>Outstanding Debt(a)</b>					
General Obligation Bonds					
General Fund (Non-Self Liquidating).....	\$ 22,115,362	\$ 26,758,626	\$ 33,028,807	\$ 34,643,757	\$ 37,066,227
Enterprise Fund (Self Liquidating).....	3,211,310	\$ 2,801,775	\$ 2,210,800	\$ 2,084,505	1,960,105
Special Revenue Fund (Self Liquidating).....	\$ 0	\$ 0	\$ 10,896,080	\$ 10,727,305	9,759,490
Total.....	<u>\$ 25,326,672</u>	<u>\$ 29,560,401</u>	<u>\$ 46,135,687</u>	<u>\$ 47,455,567</u>	<u>\$ 48,785,822</u>
Lease-Purchase Debt.....	6,341,935	6,704,599	7,288,147	7,841,383	7,785,005
Total Outstanding General Obligation Bonds and Lease-Purchase Debt.....	\$ 31,668,607	\$ 36,265,000	\$ 53,423,834	\$ 55,296,950	\$ 56,570,827
<b>Bond Sales During Fiscal Year</b>					
Non-Self Liquidating General Obligation Bonds...	\$ 3,905,025	\$ 5,150,000	\$ 7,816,275	\$ 4,914,740	\$ 5,516,560
Self Liquidating General Obligation Bonds.....	11,325	\$ 0	\$ 0	\$ 221,475	\$ 0
Self Liquidating Special Fund Revenue Bonds.....	\$ 0	\$ 0	\$ 10,896,080	\$ 0	\$ 0
Lease-Purchase Debt.....	\$ 229,105	\$ 673,975	\$ 1,235,660	\$ 907,955	\$ 882,775
<b>Debt Service (b)</b>					
Non-Self Liquidating General Obligation Bonds...	\$ 2,314,724	\$ 1,738,740	\$ 1,861,972	\$ 3,048,739	\$ 3,121,563
Lease-Purchase Debt.....	\$ 635,844	\$ 659,255	\$ 689,851	\$ 740,976	\$ 804,311
<b>General Fund Receipts (c).....</b>	<b>\$ 66,604,508</b>	<b>\$ 78,587,019</b>	<b>\$ 79,385,818</b>	<b>\$ 87,936,942</b>	<b>\$ 94,302,567</b>
Non-Self Liquidating General Obligation Bonds Debt Service as a Percentage of General Fund Receipts.....	3.48%	2.21%	2.35%	3.47%	3.31%
Lease-Purchase Debt Service as a Percentage of General Fund Receipts.....	0.95%	0.84%	0.87%	0.84%	0.85%
<b>Population (d).....</b>	<b>34,784,000</b>	<b>35,393,000</b>	<b>35,990,000</b>	<b>36,506,000</b>	<b>37,005,000</b>
Non-Self Liquidating General Obligation Bonds Outstanding per Capita.....	\$ 635.79	\$ 756.04	\$ 917.72	\$ 948.99	\$ 1,001.65
Lease-Purchase Debt Outstanding per Capita.....	\$ 182.32	\$ 189.43	\$ 202.50	\$ 214.80	\$ 210.38
<b>Personal Income (e).....</b>	<b>\$1,135,304,000</b>	<b>\$1,147,716,000</b>	<b>\$1,184,265,000</b>	<b>\$1,262,306,000</b>	<b>\$1,338,181,000</b>
Non-Self Liquidating General Obligation Bonds Outstanding as Percentage of Personal Income....	1.95%	2.33%	2.79%	2.74%	2.77%
Lease-Purchase Debt Outstanding as Percentage of Personal Income.....	0.56%	0.58%	0.62%	0.62%	0.58%

(a) As of last day of fiscal year. Includes the initial value of capital appreciation bonds rather than the accreted value.

(b) Calculated on a cash basis. Debt service costs of bonds issued in any fiscal year largely appear in subsequent fiscal year. For FY 2002-03 and FY2003-04, General Obligation Bond Debt Service was reduced through a debt restructuring program which included the use of proceeds from current refunding bonds to pay certain bonds maturing in those years.

(c) Calculated on a cash basis. General Fund Receipts includes both revenues and nonrevenues, such as borrowings the proceeds of which are deposited in the General Fund (e.g. tobacco securitization bonds).

(d) As of July 1, the beginning of the fiscal year.

(e) Source: U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/>

Annual Totals:"Pre-benchmark" Revisions: Released March 28, 2006. California Department of Finance.

SOURCES: Population: State of California, Department of Finance

Personal Income: State of California, Department of Finance; United States, Department of Commerce, Bureau of Economic Analysis (BEA)

Outstanding Debt, Bonds Sales During Fiscal Year and Debt Service: State of California, Office of the Treasurer.

General Fund Receipts: State of California, Office of the State Controller.

**GENERAL OBLIGATION AND LEASE REVENUE BONDS**  
**SUMMARY OF DEBT SERVICE REQUIREMENTS**  
**As of October 1, 2006**

	<b>Total Debt</b>		
	<b><u>Interest</u></b>	<b><u>Principal (a)</u></b>	<b><u>Total</u></b>
<b>GENERAL OBLIGATION BONDS</b>			
<b><u>GENERAL FUND NON-SELF LIQUIDATING</u></b>			
Fixed Rate	\$ 23,474,855,909.70	\$ 33,815,497,123.47	\$ 57,290,353,033.17
Variable Rate (b)	2,004,056,937.57	3,400,000,000.00	5,404,056,937.57
<b><u>ENTERPRISE FUND SELF LIQUIDATING</u></b>			
Fixed Rate	1,001,861,594.28	1,907,270,000.00	2,909,131,594.28
<b><u>SPECIAL REVENUE FUND SELF LIQUIDATING (c)</u></b>			
Fixed Rate	1,786,813,897.50	5,814,925,000.00	7,601,738,897.50
Variable Rate (d)	1,793,833,042.03	3,944,565,000.00	5,738,398,042.03
<b>REVENUE BONDS</b>			
<b><u>GENERAL FUND LEASE REVENUE</u></b>			
Lease Purchase	4,009,704,983.79	7,687,328,179.18	11,697,033,162.97
<b>General Fund and Lease Revenue Total (e)</b>	<b><u>\$ 34,071,126,364.87</u></b>	<b><u>\$ 56,569,585,302.65</u></b>	<b><u>\$ 90,640,711,667.52</u></b>

(a) Includes scheduled mandatory sinking fund payments.

(b) The estimate of future interest payments is based on rates in effect as of October 1, 2006.

(c) Economic Recovery Bonds.

(d) The estimate of future interest payments is based on rates in effect as of October 1, 2006. \$1,000,000,000 of Series 2004B bonds bear interest at fixed rates ranging from 3.00-5.00% until reset dates on July 1, 2007 and July 1, 2008, and are assumed to bear interest at the rate of 3.33% from each reset date to maturity.

(e) Estimated interest included.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS  
FOR GENERAL FUND NON-SELF LIQUIDATING BONDS**

**Fixed Rate  
As of October 1, 2006**

<b>Fiscal Year Ending June 30</b>	<b>Current Debt</b>		
	<b>Interest</b>	<b>Principal (a)</b>	<b>Total</b>
2007	1,055,794,527.92	763,630,000.00	1,819,424,527.92 (b)
2008	1,668,263,844.18	1,541,368,078.31	3,209,631,922.49
2009	1,585,171,460.00	1,612,350,000.00	3,197,521,460.00
2010	1,498,017,791.30	1,702,555,000.00	3,200,572,791.30
2011	1,408,536,444.84	1,685,474,045.16	3,094,010,490.00
2012	1,313,822,008.69	1,490,905,000.00	2,804,727,008.69
2013	1,240,784,320.00	1,216,620,000.00	2,457,404,320.00
2014	1,182,192,344.64	1,131,745,000.00	2,313,937,344.64
2015	1,128,241,527.19	1,069,425,000.00	2,197,666,527.19
2016	1,074,487,677.71	916,205,000.00	1,990,692,677.71
2017	1,027,637,997.03	888,795,000.00	1,916,432,997.03
2018	983,360,007.95	853,400,000.00	1,836,760,007.95
2019	939,569,980.47	898,760,000.00	1,838,329,980.47
2020	893,483,232.86	1,021,300,000.00	1,914,783,232.86
2021	843,334,924.77	955,485,000.00	1,798,819,924.77
2022	795,075,323.52	1,149,895,000.00	1,944,970,323.52
2023	737,116,657.06	1,184,720,000.00	1,921,836,657.06
2024	678,600,558.58	1,105,205,000.00	1,783,805,558.58
2025	621,940,942.19	1,276,660,000.00	1,898,600,942.19
2026	558,957,093.79	1,221,645,000.00	1,780,602,093.79
2027	497,936,000.04	1,252,580,000.00	1,750,516,000.04
2028	433,325,906.09	1,351,335,000.00	1,784,660,906.09
2029	366,866,543.12	1,263,670,000.00	1,630,536,543.12
2030	301,851,829.83	1,393,530,000.00	1,695,381,829.83
2031	233,963,954.68	1,132,670,000.00	1,366,633,954.68
2032	175,988,865.00	1,138,730,000.00	1,314,718,865.00
2033	118,786,238.75	1,028,205,000.00	1,146,991,238.75
2034	67,599,882.50	782,360,000.00	849,959,882.50
2035	31,395,650.00	411,630,000.00	443,025,650.00
2036	11,523,875.00	320,045,000.00	331,568,875.00
2037	1,228,500.00	54,600,000.00	55,828,500.00
<b>Total</b>	<b>\$23,474,855,909.70</b>	<b>\$33,815,497,123.47</b>	<b>\$57,290,353,033.17</b>

(a) Includes scheduled mandatory sinking fund payments.

(b) Total represents the remaining debt service requirements from November 1, 2006 through June 30, 2007.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS  
FOR GENERAL FUND NON-SELF LIQUIDATING BONDS**

**Variable Rate  
As of October 1, 2006**

<b>Fiscal Year Ending June 30</b>	<b>Current Debt</b>		
	<b>Interest (a)</b>	<b>Principal (b)</b>	<b>Total</b>
2007	82,618,589.05	19,000,000.00	101,618,589.05 (c)
2008	121,002,944.17	0.00	121,002,944.17
2009	120,432,270.27	0.00	120,432,270.27
2010	120,563,510.00	0.00	120,563,510.00
2011	120,872,676.67	0.00	120,872,676.67
2012	120,710,413.18	0.00	120,710,413.18
2013	120,958,888.31	0.00	120,958,888.31
2014	120,269,619.26	0.00	120,269,619.26
2015	120,279,341.48	0.00	120,279,341.48
2016	120,848,841.60	67,455,000.00	188,303,841.60
2017	116,903,372.12	372,685,000.00	489,588,372.12
2018	103,695,396.42	476,190,000.00	579,885,396.42
2019	87,448,920.35	238,680,000.00	326,128,920.35
2020	78,329,759.41	230,050,000.00	308,379,759.41
2021	70,437,692.87	183,510,000.00	253,947,692.87
2022	64,450,147.54	97,060,000.00	161,510,147.54
2023	60,684,663.58	119,800,000.00	180,484,663.58
2024	56,142,482.83	296,540,000.00	352,682,482.83
2025	45,529,278.54	201,180,000.00	246,709,278.54
2026	37,773,550.89	346,030,000.00	383,803,550.89
2027	26,236,693.57	74,285,000.00	100,521,693.57
2028	23,784,250.57	77,260,000.00	101,044,250.57
2029	20,804,995.13	110,350,000.00	131,154,995.13
2030	16,997,544.57	114,760,000.00	131,757,544.57
2031	12,890,074.99	119,350,000.00	132,240,074.99
2032	8,750,769.53	124,125,000.00	132,875,769.53
2033	4,338,918.84	129,090,000.00	133,428,918.84
2034	88,855.86	1,600,000.00	1,688,855.86
2035	35,910.00	0.00	35,910.00
2036	36,065.64	0.00	36,065.64
2037	35,754.36	0.00	35,754.36
2038	35,910.00	0.00	35,910.00
2039	35,910.00	0.00	35,910.00
2040	32,925.97	1,000,000.00	1,032,925.97
<b>Total</b>	<b>\$2,004,056,937.57</b>	<b>\$3,400,000,000.00</b>	<b>\$5,404,056,937.57</b>

(a) The estimate of future interest payments is based on rates in effect as of October 1, 2006. The interest rates for the daily, weekly and auction rate bonds range from 3.25 - 3.75%.

(b) Includes scheduled mandatory sinking fund payments.

(c) Total represents the remaining estimated debt service requirements from November 1, 2006 through June 30, 2007.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS  
FOR SPECIAL REVENUE FUND SELF LIQUIDATING BONDS  
Fixed Rate  
As of October 1, 2006**

<b>Fiscal Year Ending June 30</b>	<b>Current Debt</b>		
	<b><u>Interest</u></b>	<b><u>Principal (a)</u></b>	<b><u>Total</u></b>
2007	144,240,253.23	185,530,000.00	329,770,253.23 (b)
2008	276,067,262.50	393,925,000.00	669,992,262.50
2009	256,912,012.50	449,920,000.00	706,832,012.50
2010	234,396,687.50	506,870,000.00	741,266,687.50
2011	208,777,650.00	549,060,000.00	757,837,650.00
2012	180,544,622.50	289,375,000.00	469,919,622.50
2013	158,128,415.00	603,520,000.00	761,648,415.00
2014	127,216,935.00	606,870,000.00	734,086,935.00
2015	95,264,431.77	636,645,000.00	731,909,431.77
2016	61,418,235.00	702,140,000.00	763,558,235.00
2017	32,768,530.00	451,820,000.00	484,588,530.00
2018	10,817,612.50	438,250,000.00	449,067,612.50
2019	47,500.00	0.00	47,500.00
2020	47,500.00	0.00	47,500.00
2021	47,500.00	0.00	47,500.00
2022	47,500.00	0.00	47,500.00
2023	47,500.00	0.00	47,500.00
2024	23,750.00	1,000,000.00	1,023,750.00
<b>Total</b>	<b><u>\$1,786,813,897.50</u></b>	<b><u>\$5,814,925,000.00</u></b>	<b><u>\$7,601,738,897.50</u></b>

(a) Includes scheduled mandatory sinking fund payments.

(b) Total represents the remaining debt service requirements from November 1, 2006 through June 30, 2007.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS FOR  
SPECIAL REVENUE FUND SELF LIQUIDATING BONDS**

**Variable Rate**

**As of October 1, 2006**

<b>Fiscal Year Ending June 30</b>	<b>Current Debt</b>		
	<b>Interest (a)</b>	<b>Principal (b)</b>	<b>Total</b>
2007.....	\$ 113,192,118.18	\$ -	\$ 113,192,118.18 (c)
2008.....	146,924,830.69	-	146,924,830.69
2009.....	141,325,023.31	-	141,325,023.31
2010.....	139,688,327.00	-	139,688,327.00
2011.....	139,688,327.00	-	139,688,327.00
2012.....	139,858,752.20	-	139,858,752.20
2013.....	140,100,851.54	-	140,100,851.54
2014.....	139,396,852.13	-	139,396,852.13
2015.....	139,396,852.13	-	139,396,852.13
2016.....	139,858,752.20	-	139,858,752.20
2017.....	137,458,796.80	297,410,000.00	434,868,796.80
2018.....	123,625,898.06	651,985,000.00	775,610,898.06
2019.....	88,831,141.72	985,780,000.00	1,074,611,141.72
2020.....	48,324,364.89	1,002,650,000.00	1,050,974,364.89
2021.....	14,996,188.11	773,865,000.00	788,861,188.11
2022.....	909,939.70	226,625,000.00	227,534,939.70
2023.....	223,725.00	-	223,725.00
2024.....	32,301.37	6,250,000.00	6,282,301.37
<b>Total .....</b>	<b>\$ 1,793,833,042.03</b>	<b>\$ 3,944,565,000.00</b>	<b>\$ 5,738,398,042.03</b>

(a) The estimate of future interest payments is based on rates in effect as of October 1, 2006. The interest rates for the daily and weekly rate bonds range from 3.50-3.79%. \$1,000,000,000 of Series 2004B bonds bear interest at fixed rates ranging from 3.00-5.00% until reset dates on July 1, 2007 and July 1, 2008, and are assumed to bear interest at the rate of 3.33% from each reset date to maturity.

(b) Includes scheduled mandatory sinking fund payments.

(c) Total represents the remaining estimated debt service requirements from November 1, 2006 through June 30, 2007.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS  
FOR ENTERPRISE FUND SELF LIQUIDATING BONDS  
Fixed Rate  
As of October 1, 2006**

<b>Fiscal Year Ending June 30</b>	<b>Current Debt</b>			
	<b><u>Interest</u></b>	<b><u>Principal (a)</u></b>	<b><u>Total</u></b>	
2007	83,352,295.41	73,325,000.00	156,677,295.41	(b)
2008	96,617,986.04	136,430,000.00	233,047,986.04	
2009	86,829,718.75	135,340,000.00	222,169,718.75	
2010	77,556,794.05	118,190,000.00	195,746,794.05	
2011	70,227,072.02	86,480,000.00	156,707,072.02	
2012	65,594,219.75	100,895,000.00	166,489,219.75	
2013	61,222,059.37	93,395,000.00	154,617,059.37	
2014	56,770,503.50	107,720,000.00	164,490,503.50	
2015	51,703,008.05	114,260,000.00	165,963,008.05	
2016	45,912,866.90	121,930,000.00	167,842,866.90	
2017	39,688,996.79	129,925,000.00	169,613,996.79	
2018	34,214,708.99	90,035,000.00	124,249,708.99	
2019	29,981,716.61	85,850,000.00	115,831,716.61	
2020	26,508,908.61	53,340,000.00	79,848,908.61	
2021	23,670,512.50	46,365,000.00	70,035,512.50	
2022	21,158,096.25	41,990,000.00	63,148,096.25	
2023	19,372,992.01	22,480,000.00	41,852,992.01	
2024	18,040,105.52	27,025,000.00	45,065,105.52	
2025	16,406,841.91	34,350,000.00	50,756,841.91	
2026	14,732,973.75	28,805,000.00	43,537,973.75	
2027	13,195,135.00	28,645,000.00	41,840,135.00	
2028	11,828,360.00	22,215,000.00	34,043,360.00	
2029	10,478,760.00	27,955,000.00	38,433,760.00	
2030	8,737,392.50	36,100,000.00	44,837,392.50	
2031	6,821,867.50	33,920,000.00	40,741,867.50	
2032	4,894,975.00	36,375,000.00	41,269,975.00	
2033	2,858,227.50	37,930,000.00	40,788,227.50	
2034	1,565,500.00	10,000,000.00	11,565,500.00	
2035	1,060,500.00	10,000,000.00	11,060,500.00	
2036	631,250.00	7,000,000.00	7,631,250.00	
2037	227,250.00	9,000,000.00	9,227,250.00	
<b>Total</b>	<b><u>\$1,001,861,594.28</u></b>	<b><u>\$1,907,270,000.00</u></b>	<b><u>\$2,909,131,594.28</u></b>	

(a) Includes scheduled mandatory sinking fund payments.

(b) Total represents the remaining debt service requirements from November 1, 2006 through June 30, 2007.

SOURCE: State of California, Office of the Treasurer.



**SCHEDULE OF DEBT SERVICE REQUIREMENTS  
FOR LEASE-PURCHASE DEBT  
As of October 1, 2006**

<b>Fiscal Year Ending June 30</b>	<b>Current Debt</b>		
	<b><u>Interest</u></b>	<b><u>Principal (a)</u></b>	<b><u>Total</u></b>
2007	323,091,707.37	276,002,025.00	599,093,732.37 (b)
2008	382,897,237.14	388,286,787.98	771,184,025.12
2009	368,172,844.19	410,977,732.44	779,150,576.63
2010	342,583,653.49	401,636,633.76	744,220,287.25
2011	311,655,160.18	414,720,000.00	726,375,160.18
2012	290,905,188.67	400,420,000.00	691,325,188.67
2013	270,450,321.75	411,735,000.00	682,185,321.75
2014	249,310,741.96	417,425,000.00	666,735,741.96
2015	227,559,644.95	440,320,000.00	667,879,644.95
2016	204,724,558.68	424,510,000.00	629,234,558.68
2017	182,330,361.93	432,715,000.00	615,045,361.93
2018	160,074,237.08	450,620,000.00	610,694,237.08
2019	137,291,500.78	413,230,000.00	550,521,500.78
2020	116,111,500.37	387,700,000.00	503,811,500.37
2021	97,477,601.12	328,275,000.00	425,752,601.12
2022	80,614,318.74	304,245,000.00	384,859,318.74
2023	66,493,734.12	257,710,000.00	324,203,734.12
2024	54,251,303.25	174,515,000.00	228,766,303.25
2025	45,428,984.90	183,320,000.00	228,748,984.90
2026	36,626,670.62	174,340,000.00	210,966,670.62
2027	27,723,630.00	183,205,000.00	210,928,630.00
2028	18,444,577.50	176,825,000.00	195,269,577.50
2029	10,230,076.25	117,655,000.00	127,885,076.25
2030	4,472,807.50	86,370,000.00	90,842,807.50
2031	782,621.25	30,570,000.00	31,352,621.25
<b>Total</b>	<b><u>\$4,009,704,983.79</u></b>	<b><u>\$7,687,328,179.18</u></b>	<b><u>\$11,697,033,162.97</u></b>

(a) Includes scheduled mandatory sinking fund payments.

(b) Total represents the remaining debt service requirements from November 1, 2006 through June 30, 2007.

SOURCE: State of California, Office of the Treasurer.

**STATE PUBLIC WORKS BOARD AND  
OTHER LEASE-PURCHASE FINANCING  
OUTSTANDING ISSUES  
October 1, 2006**

<u>Name of Issue</u>	<u>Outstanding</u>
----------------------	--------------------

**GENERAL FUND SUPPORTED ISSUES:**

**State Public Works Board**

California Community Colleges	542,565,000
California Department of Corrections *	2,201,350,814
California Youth Authority	15,265,000
Office of Energy Assessments (a)	36,550,000
The Regents of the University of California (b) *	1,777,327,365
Trustees of the California State University	515,265,000
Various State Office Buildings	1,904,235,000
<b>Total State Public Works Board Issues</b>	<b>\$6,992,558,179</b>

<b>Total Other State Building Lease Purchase Issues (c)</b>	<b>\$694,770,000</b>
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<b>Total General Fund Supported Issues</b>	<b>\$7,687,328,179</b>
--	------------------------

**SPECIAL FUND SUPPORTED ISSUES:**

East Bay State Building Authority *	55,946,813
San Bernardino Joint Powers Financing Authority	49,355,000
San Francisco State Building Authority (d)	29,050,000
<b>Total Special Fund Supported Issues</b>	<b>\$134,351,813</b>

<b>TOTAL</b>	<b>\$7,821,679,992</b>
--------------	------------------------

\* Includes the initial value of capital appreciation bonds rather than the accreted value.

(a) This program is self-liquidating based on energy cost savings.

(b) The Regents' obligations to the State Public Works Board are payable from lawfully available funds of The Regents which are held in The Regents' treasury funds and are separate from the State General Fund. A portion of The Regents' annual budget is derived from General Fund appropriations.

(c) Includes \$162,305,000 Sacramento City Financing Authority Lease Revenue Bonds State of California - Cal EPA Building, 1998 Series A, which are supported by lease rentals from the California Environmental Protection Agency; these rental payments are subject to annual appropriation by the State Legislature.

(d) The sole tenant is the California Public Utilities Commission.

SOURCE: State of California, Office of the Treasurer.

**STATE AGENCY REVENUE BONDS  
AND CONDUIT FINANCING  
As of June 30, 2006**

<b><u>Issuing Agency</u></b>	<b><u>Outstanding<sup>(a)(b)</sup></u></b>
<b><u>State Programs Financing:</u></b>	
California Department of Transportation - GARVEE.....	\$ 525,460,000
California Infrastructure and Economic Development Bank <sup>(c)</sup> .....	413,125,000
California State University.....	2,053,253,000
Department of Water Resources - Central Valley Project.....	2,364,060,000
Department of Water Resources - Power Supply Program.....	10,501,820,000
The Regents of the University of California.....	5,893,755,000
<b><u>Housing Financing:</u></b>	
California Housing Finance Agency.....	7,427,157,837
Veterans Revenue Debenture.....	543,360,000
<b><u>Conduit Financing:</u></b>	
California Alternative Energy and Advanced Transportation Financing Authority.....	53,235,000
California Educational Facilities Authority.....	3,362,045,358
California Health Facilities Financing Authority.....	7,540,949,246
California Infrastructure and Economic Development Bank <sup>(c)</sup> .....	3,881,838,293
California Pollution Control Financing Authority.....	3,674,186,822
California Student Loan Authority.....	38,155,000
<b>TOTAL.....</b>	<b><u>\$ 48,272,400,556</u></b>

<sup>(a)</sup> Totals for California Department of Transportation (GARVEE), California State University, Department of Water Resources and Veterans Revenue Debenture were provided by the State of California, Office of the Treasurer. All other totals were provided by the listed issuing agency.

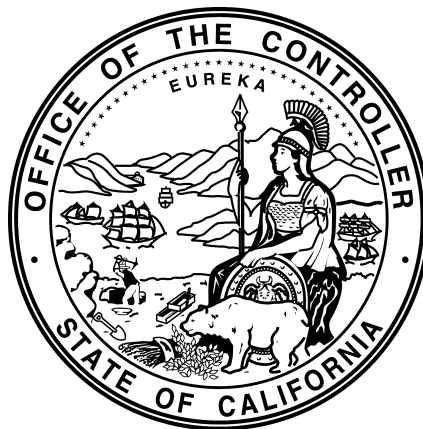
<sup>(b)</sup> Does not include the "tobacco settlement revenue bonds" issued by Golden State Tobacco Securitization Corporation.

<sup>(c)</sup> Does not include \$6 billion of "rate reduction bonds" issued by special purpose trusts for the benefit of four investor-owned electric utility companies representing interests in certain electric rate surcharges.

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# **STATEMENT of GENERAL FUND CASH RECEIPTS and DISBURSEMENTS**

**June 2006**



**STEVE WESTLY**  
California State Controller

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**STEVE WESTLY**  
**California State Controller**

July 10, 2006

Users of the Statement of General Fund Cash Receipts and Disbursements:

Attached are the Statements of General Fund Cash Receipts and Disbursements for the period July 1, 2005 through June 30, 2006. These statements reflect the State of California's General Fund cash position and compare actual receipts and disbursements for the 2005-06 fiscal year to cash flow estimates prepared by the Department of Finance for the 2006-07 May Revision and the 2005-06 Budget Act. These statements are prepared in compliance with Provision 9 of Budget Act item 0840-001-0001.

Attachment A compares actual receipts and disbursements to date for the 2005-06 fiscal year to cash flow estimates published in the 2006-07 May Revision. These cash flow estimates are predicated on projections and assumptions made by the Department of Finance in preparation of the May Revision.

Attachment B compares actual receipts and disbursements to date for the 2005-06 fiscal year to cash flow estimates prepared by the Department of Finance based upon the 2005-06 Budget Act. Prior year actual amounts are also displayed for comparative purposes.

These statements are also available at <http://www.sco.ca.gov/ard/cash/index.shtml>.

Any questions concerning this report may be directed to Michael Carter, Chief Operating Officer, at (916) 552-8080.

Sincerely,

Original Signed By:

STEVE WESTLY

**STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS**  
**A Comparison of Actual to 2006-07 May Revision Estimates**  
**(Amounts in thousands)**  
**Attachment A**

	July 1 through June 30				
	2006				2005
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
GENERAL FUND BEGINNING CASH BALANCE	\$ 6,436,788	\$ 6,436,788	\$ -	-	\$ 538,359
Add Receipts:					
Revenues	93,325,544	93,221,710	103,834	0.1	85,447,296
Nonrevenues	977,023	614,461	362,562	59.0	2,489,646
Total Receipts	94,302,567	93,836,171	466,396	0.5	87,936,942
Less Disbursements:					
State Operations	21,720,678	21,838,093	(117,415)	(0.5)	20,035,355
Local Assistance	67,401,131	70,173,436	(2,772,305)	(4.0)	61,717,948
Capital Outlay	1,450,966	1,558,795	(107,829)	(6.9)	84,665
Nongovernmental	933,779	691,179	242,600	35.1	200,545
Total Disbursements	91,506,554	94,261,503	(2,754,949)	(2.9)	82,038,513
Receipts Over / (Under) Disbursements	2,796,013	(425,332)	3,221,345	-	5,898,429
Net Increase / (Decrease) in Temporary Loans	-	-	-	-	-
GENERAL FUND ENDING CASH BALANCE	9,232,801	6,011,456	3,221,345	53.6	6,436,788
Special Fund for Economic Uncertainties	1,295,007	1,302,023	(7,016)	(0.5)	744,541
TOTAL CASH	\$ 10,527,808	\$ 7,313,479	\$ 3,214,329	44.0	\$ 7,181,329
BORROWABLE RESOURCES					
Available Borrowable Resources	\$ 11,708,865	\$ 11,407,884	\$ 300,981	2.6	\$ 10,005,342
Outstanding Loans (b)	-	-	-	-	-
Unused Borrowable Resources	\$ 11,708,865	\$ 11,407,884	\$ 300,981	2.6	\$ 10,005,342

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

- (a) A Statement of Estimated Cash Flow for the 2005-06 fiscal year prepared by the Department of Finance for the 2006-07 May Revision. Any projections or estimates are set forth as such and not as representations of fact.
- (b) Cumulative loan balance consisted of no internal or external borrowing.
- (c) Negative balances are the result of repayments received that are greater than disbursements made.
- (d) July 2005 Other Local Assistance includes \$1.1 billion for the motor vehicle license fee "backfill gap" payment to Local Governments.
- (e) Includes School Facility Aid Program that was previously displayed separately.



**SCHEDULE OF CASH RECEIPTS**

(Amounts in thousands)

	Month of June		July 1 through June 30				2005
			2006				
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	\$ 31,985	\$ 25,412	\$ 318,518	\$ 313,000	\$ 5,518	1.8	\$ 312,671
Corporation Tax	1,698,308	1,714,629	10,436,025	10,254,710	181,315	1.8	12,496,503
Cigarette Tax	3,975	13,416	113,256	116,000	(2,744)	(2.4)	122,206
Estate, Inheritance, and Gift Tax	1,549	22,367	124,849	115,000	9,849	8.6	452,679
Insurance Companies Tax	464,393	474,653	2,212,739	2,239,000	(26,261)	(1.2)	2,228,317
Personal Income Tax	4,985,925	4,409,751	49,946,731	49,966,000	(19,269)	(0.0)	42,476,251
Retail Sales and Use Taxes	2,861,534	2,798,102	27,537,859	27,384,000	153,859	0.6	25,506,531
Pooled Money Investment Interest	40,667	25,467	380,111	448,000	(67,889)	(15.2)	167,339
Not Otherwise Classified	156,654	125,627	2,255,456	2,386,000	(130,544)	(5.5)	1,684,799
Total Revenues	10,244,990	9,609,424	93,325,544	93,221,710	103,834	0.1	85,447,296
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	-	-	-	-	1,448,000
Transfers from Other Funds	(44,706)	71,391	240,562	149,335	91,227	61.1	487,988
Miscellaneous	89,096	32,333	736,461	465,126	271,335	58.3	553,658
Total Nonrevenues	44,390	103,724	977,023	614,461	362,562	59.0	2,489,646
Total Receipts	\$ 10,289,380	\$ 9,713,148	\$ 94,302,567	\$ 93,836,171	\$ 466,396	0.5	\$ 87,936,942

See notes on page 1.

**SCHEDULE OF CASH DISBURSEMENTS**

(Amounts in thousands)

	Month of June		July 1 through June 30					2005
			2006					
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual	
					Amount	%		
STATE OPERATIONS (c)								
Legislative/Judicial/Executive	\$ 60,130	\$ 57,051	\$ 1,398,060	\$ 1,396,924	\$ 1,136	0.1	\$ 1,298,574	
State and Consumer Services	37,403	40,838	527,951	542,005	(14,054)	(2.6)	509,350	
Business, Transportation and Housing	478	(313)	5,517	4,540	977	21.5	3,386	
Resources	30,834	39,381	790,643	887,730	(97,087)	(10.9)	761,199	
Environmental Protection Agency	7,179	3,323	60,783	59,975	808	1.3	50,461	
Health and Human Services:								
Health Services	16,770	6,494	296,825	293,741	3,084	1.0	258,528	
Mental Health Hospitals	68,891	30,408	731,931	836,307	(104,376)	(12.5)	571,258	
Other Health and Human Services	(28,318)	20,675	661,863	586,859	75,004	12.8	589,512	
Education:								
University of California	10,099	9,982	2,842,562	2,836,229	6,333	0.2	2,670,057	
State Universities and Colleges	277,461	309,709	2,599,834	2,589,700	10,134	0.4	2,488,257	
Other Education	10,089	9,193	154,754	161,071	(6,317)	(3.9)	146,158	
Corrections and Youth Authority	583,571	522,458	7,211,404	7,156,843	54,561	0.8	6,364,036	
General Government	95,242	130,894	1,226,683	1,307,907	(81,224)	(6.2)	1,265,848	
Public Employees Retirement								
System	(138,914)	(138,842)	(1,553)	-	(1,553)	-	(63,151)	
Debt Service	293,751	220,633	3,130,365	3,105,329	25,036	0.8	3,032,522	
Interest on Loans	85,808	152,702	83,056	72,933	10,123	13.9	89,360	
Total State Operations	1,410,474	1,414,586	21,720,678	21,838,093	(117,415)	(0.5)	20,035,355	
LOCAL ASSISTANCE (c)								
Public Schools - K-12	273,680	199,955	31,019,476	33,500,123	(2,480,647)	(7.4)	29,428,525	
Community Colleges	139,257	137,572	3,342,326	3,681,778	(339,452)	(9.2)	3,042,733	
Debt Service-School Building Bonds	-	-	-	(7,961)	7,961	-	-	
Contributions to State Teachers'								
Retirement System	1	-	1,081,064	1,081,064	-	-	1,148,792	
Other Education (e)	61,152	132,492	2,709,883	2,285,177	424,706	18.6	2,325,743	
Corrections and Youth Authority	24,065	136	293,729	341,236	(47,507)	(13.9)	214,051	
Dept. of Alcohol and Drug Program	10,176	(4,502)	222,127	235,651	(13,524)	(5.7)	227,987	
Dept. of Health Services:								
Medical Assistance Program	481,388	987,446	12,148,396	12,753,185	(604,789)	(4.7)	11,484,288	
Other Health Services	41,753	36,429	598,510	379,194	219,316	57.8	495,354	
Dept. of Developmental Services	5,224	32,627	1,697,585	1,837,874	(140,289)	(7.6)	1,604,536	
Dept. of Mental Health	149,330	(138,426)	649,150	436,158	212,992	48.8	98,471	
Dept. of Social Services:								
SSI/SSP/IHSS	413,346	230,553	4,741,450	4,715,322	26,128	0.6	4,580,336	
CalWORKs	105,352	82,207	2,913,578	2,960,959	(47,381)	(1.6)	2,671,866	
Other Social Services	115,323	62,660	1,237,135	1,186,198	50,937	4.3	1,145,377	
Tax Relief	2,159	6,594	662,584	666,759	(4,175)	(0.6)	667,334	
Other Local Assistance (d)	68,332	70,393	4,084,138	4,120,719	(36,581)	(0.9)	2,582,555	
Total Local Assistance	1,890,538	1,836,136	67,401,131	70,173,436	(2,772,305)	(4.0)	61,717,948	

See notes on page 1.

(Continued)

**SCHEDULE OF CASH DISBURSEMENTS (Continued)**

(Amounts in thousands)

	Month of June		July 1 through June 30				2005
			2006				
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
CAPITAL OUTLAY	382,077	13,646	1,450,966	1,558,795	(107,829)	(6.9)	84,665
NONGOVERNMENTAL (c)							
Transfer to Special Fund for Economic Uncertainties	(104,807)	-	557,439	557,439	-	-	-
Transfer to Other Funds	15,045	45,950	232,993	174,832	58,161	33.3	141,938
Transfer to Revolving Fund	(32,398)	(17,674)	20,195	-	20,195	-	35,650
Advance:							
State-County Property Tax Administration Program	-	-	-	-	-	-	-
Social Welfare Federal Fund	22,410	(1,061)	19,246	-	19,246	-	(37,582)
Tax Relief and Refund Account	(22,500)	(56,700)	-	-	-	-	-
Counties for Social Welfare	664,880	560,974	103,906	(41,092)	144,998	-	60,539
Total Nongovernmental	542,630	531,489	933,779	691,179	242,600	35.1	200,545
Total Disbursements	\$ 4,225,719	\$ 3,795,857	\$ 91,506,554	\$ 94,261,503	\$ (2,754,949)	(2.9)	\$ 82,038,513
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	\$ -	\$ -	\$ -	\$ -	\$ -	-	\$ -
Other Internal Sources	-	-	-	-	-	-	-
Revenue Anticipation Notes	(3,000,000)	(6,000,000)	-	-	-	-	-
Net Increase / (Decrease) Loans	\$ (3,000,000)	\$ (6,000,000)	\$ -	\$ -	\$ -	-	\$ -

See notes on page 1.

(Concluded)

**COMPARATIVE STATEMENT OF REVENUES RECEIVED**  
**All Governmental Cost Funds**  
**(Amounts in thousands)**

July 1 through June 30				
	General Fund		Special Funds	
	2006	2005	2006	2005
<b>MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:</b>				
Alcoholic Beverage Excise Taxes	\$ 318,518	\$ 312,671	\$ -	\$ -
Corporation Tax	10,436,025	12,496,503	-	-
Cigarette Tax	113,256	122,206	938,219	1,002,794
Estate, Inheritance, and Gift Tax	124,849	452,679	-	-
Insurance Companies Tax	2,212,739	2,228,317	-	-
Motor Vehicle Fuel Tax:				
Gasoline Tax	-	-	2,860,395	2,880,441
Diesel & Liquid Petroleum Gas	-	-	556,681	523,839
Jet Fuel Tax	-	-	(5,180)	10,966
Vehicle License Fees	-	-	2,247,414	2,143,158
Motor Vehicle Registration and Other Fees	-	-	2,861,631	2,741,376
Personal Income Tax	49,946,731	42,476,251	898,986	173,992
Retail Sales and Use Taxes	27,537,859	25,506,531	7,351,991	6,798,285
Pooled Money Investment Interest	380,111	167,339	452	149
<b>Total Major Taxes, Licenses, and Investment Income</b>	<b>91,070,088</b>	<b>83,762,497</b>	<b>17,710,589</b>	<b>16,275,000</b>
<b>NOT OTHERWISE CLASSIFIED:</b>				
Alcoholic Beverage License Fee	4,672	3,404	40,621	44,400
Electrical Energy Tax	-	-	604,943	574,073
Private Rail Car Tax	6,948	6,577	-	-
Penalties on Traffic Violations	-	-	93,421	92,162
Health Care Receipts	15,179	8,968	-	-
Revenues from State Lands	270,567	185,447	21,430	500
Abandoned Property	334,335	707,306	-	-
Trial Court Revenues	59,860	56,556	1,211,038	1,222,480
Horse Racing Fees	2,391	2,605	35,596	35,836
Miscellaneous	1,561,504	713,936	7,787,092	6,882,047
<b>Not Otherwise Classified</b>	<b>2,255,456</b>	<b>1,684,799</b>	<b>9,794,141</b>	<b>8,851,498</b>
<b>Total Revenues, All Governmental Cost Funds</b>	<b>\$ 93,325,544</b>	<b>\$ 85,447,296</b>	<b>\$ 27,504,730</b>	<b>\$ 25,126,498</b>

See notes on page 1.

**STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS**  
**A Comparison of Actual to 2005-06 Budget Act Estimates**  
**(Amounts in thousands)**  
**Attachment B**

	July 1 through June 30				
	2006				2005
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
GENERAL FUND BEGINNING CASH BALANCE	\$ 6,436,788	\$ 6,436,788	\$ -	-	\$ 538,359
Add Receipts:					
Revenues	93,325,544	83,750,000	9,575,544	11.4	85,447,296
Nonrevenues	977,023	619,102	357,921	57.8	2,489,646
Total Receipts	94,302,567	84,369,102	9,933,465	11.8	87,936,942
Less Disbursements:					
State Operations	21,720,678	21,589,628	131,050	0.6	20,035,355
Local Assistance	67,401,131	68,451,949	(1,050,818)	(1.5)	61,717,948
Capital Outlay	1,450,966	1,425,936	25,030	1.8	84,665
Nongovernmental	933,779	769,488	164,291	21.4	200,545
Total Disbursements	91,506,554	92,237,001	(730,447)	(0.8)	82,038,513
Receipts Over / (Under) Disbursements	2,796,013	(7,867,899)	10,663,912	-	5,898,429
Net Increase / (Decrease) in Temporary Loans	-	1,431,111	(1,431,111)	(100.0)	-
GENERAL FUND ENDING CASH BALANCE	9,232,801	-	9,232,801	-	6,436,788
Special Fund for Economic Uncertainties	1,295,007	-	1,295,007	-	744,541
TOTAL CASH	\$ 10,527,808	\$ -	\$ 10,527,808	-	\$ 7,181,329
BORROWABLE RESOURCES					
Available Borrowable Resources	\$ 11,708,865	\$ 10,232,911	\$ 1,475,954	14.4	\$ 10,005,342
Outstanding Loans (b)	-	1,431,111	(1,431,111)	(100.0)	-
Unused Borrowable Resources	\$ 11,708,865	\$ 8,801,800	\$ 2,907,065	33.0	\$ 10,005,342

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

- (a) A Statement of Estimated Cash Flow for the 2005-06 fiscal year prepared by the Department of Finance for the Budget Act of 2005. Any projections or estimates are set forth as such and not as representations of fact.
- (b) Cumulative loan balance consisted of no internal or external borrowing.
- (c) Negative balances are the result of repayments received that are greater than disbursements made.
- (d) July 2005 Other Local Assistance includes \$1.1 billion for the motor vehicle license fee "backfill gap" payment to Local Governments.
- (e) Includes School Facility Aid Program that was previously displayed separately.

**SCHEDULE OF CASH RECEIPTS**

(Amounts in thousands)

	Month of June		July 1 through June 30				
			2006				2005
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	\$ 31,985	\$ 25,412	\$ 318,518	\$ 314,000	\$ 4,518	1.4	\$ 312,671
Corporation Tax	1,698,308	1,714,629	10,436,025	8,858,000	1,578,025	17.8	12,496,503
Cigarette Tax	3,975	13,416	113,256	117,000	(3,744)	(3.2)	122,206
Estate, Inheritance, and Gift Tax	1,549	22,367	124,849	69,000	55,849	80.9	452,679
Insurance Companies Tax	464,393	474,653	2,212,739	2,299,000	(86,261)	(3.8)	2,228,317
Personal Income Tax	4,985,925	4,409,751	49,946,731	42,541,000	7,405,731	17.4	42,476,251
Retail Sales and Use Taxes	2,861,534	2,798,102	27,537,859	26,937,000	600,859	2.2	25,506,531
Pooled Money Investment Interest	40,667	25,467	380,111	357,000	23,111	6.5	167,339
Not Otherwise Classified	156,654	125,627	2,255,456	2,258,000	(2,544)	(0.1)	1,684,799
Total Revenues	10,244,990	9,609,424	93,325,544	83,750,000	9,575,544	11.4	85,447,296
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	-	-	-	-	1,448,000
Transfers from Other Funds	(44,706)	71,391	240,562	139,599	100,963	72.3	487,988
Miscellaneous	89,096	32,333	736,461	479,503	256,958	53.6	553,658
Total Nonrevenues	44,390	103,724	977,023	619,102	357,921	57.8	2,489,646
Total Receipts	\$ 10,289,380	\$ 9,713,148	\$ 94,302,567	\$ 84,369,102	\$ 9,933,465	11.8	\$ 87,936,942

See notes on page 1.

**SCHEDULE OF CASH DISBURSEMENTS**

(Amounts in thousands)

	Month of June		July 1 through June 30					2005
			2006					
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual	
					Amount	%		
STATE OPERATIONS (c)								
Legislative/Judicial/Executive	\$ 60,130	\$ 57,051	\$ 1,398,060	\$ 1,371,490	\$ 26,570	1.9	\$ 1,298,574	
State and Consumer Services	37,403	40,838	527,951	543,534	(15,583)	(2.9)	509,350	
Business, Transportation and Housing	478	(313)	5,517	4,832	685	14.2	3,386	
Resources	30,834	39,381	790,643	859,638	(68,995)	(8.0)	761,199	
Environmental Protection Agency	7,179	3,323	60,783	64,918	(4,135)	(6.4)	50,461	
Health and Human Services:								
Health Services	16,770	6,494	296,825	259,951	36,874	14.2	258,528	
Mental Health Hospitals	68,891	30,408	731,931	855,190	(123,259)	(14.4)	571,258	
Other Health and Human Services	(28,318)	20,675	661,863	577,352	84,511	14.6	589,512	
Education:								
University of California	10,099	9,982	2,842,562	2,840,324	2,238	0.1	2,670,057	
State Universities and Colleges	277,461	309,709	2,599,834	2,607,871	(8,037)	(0.3)	2,488,257	
Other Education	10,089	9,193	154,754	155,959	(1,205)	(0.8)	146,158	
Corrections and Youth Authority	583,571	522,458	7,211,404	6,794,829	416,575	6.1	6,364,036	
General Government	95,242	130,894	1,226,683	1,263,714	(37,031)	(2.9)	1,265,848	
Public Employees Retirement								
System	(138,914)	(138,842)	(1,553)	-	(1,553)	-	(63,151)	
Debt Service	293,751	220,633	3,130,365	3,301,365	(171,000)	(5.2)	3,032,522	
Interest on Loans	85,808	152,702	83,056	88,661	(5,605)	(6.3)	89,360	
Total State Operations	1,410,474	1,414,586	21,720,678	21,589,628	131,050	0.6	20,035,355	
LOCAL ASSISTANCE (c)								
Public Schools - K-12	273,680	199,955	31,019,476	32,198,747	(1,179,271)	(3.7)	29,428,525	
Community Colleges	139,257	137,572	3,342,326	3,446,223	(103,897)	(3.0)	3,042,733	
Debt Service-School Building Bonds	-	-	-	(6,241)	6,241	-	-	
Contributions to State Teachers'								
Retirement System	1	-	1,081,064	1,081,064	-	-	1,148,792	
Other Education (e)	61,152	132,492	2,709,883	2,284,525	425,358	18.6	2,325,743	
Corrections and Youth Authority	24,065	136	293,729	254,434	39,295	15.4	214,051	
Dept. of Alcohol and Drug Program	10,176	(4,502)	222,127	235,191	(13,064)	(5.6)	227,987	
Dept. of Health Services:								
Medical Assistance Program	481,388	987,446	12,148,396	12,905,712	(757,316)	(5.9)	11,484,288	
Other Health Services	41,753	36,429	598,510	412,542	185,968	45.1	495,354	
Dept. of Developmental Services	5,224	32,627	1,697,585	1,873,250	(175,665)	(9.4)	1,604,536	
Dept. of Mental Health	149,330	(138,426)	649,150	438,466	210,684	48.1	98,471	
Dept. of Social Services:								
SSI/SSP/IHSS	413,346	230,553	4,741,450	4,747,314	(5,864)	(0.1)	4,580,336	
CalWORKs	105,352	82,207	2,913,578	2,726,376	187,202	6.9	2,671,866	
Other Social Services	115,323	62,660	1,237,135	1,109,028	128,107	11.6	1,145,377	
Tax Relief	2,159	6,594	662,584	671,396	(8,812)	(1.3)	667,334	
Other Local Assistance (d)	68,332	70,393	4,084,138	4,073,922	10,216	0.3	2,582,555	
Total Local Assistance	1,890,538	1,836,136	67,401,131	68,451,949	(1,050,818)	(1.5)	61,717,948	

See notes on page 1.

(Continued)

**SCHEDULE OF CASH DISBURSEMENTS (Continued)**

(Amounts in thousands)

	Month of June		July 1 through June 30				2005	
			2006					
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate			Actual
					Amount	%		
CAPITAL OUTLAY	382,077	13,646	1,450,966	1,425,936	25,030	1.8	84,665	
NONGOVERNMENTAL (c)								
Transfer to Special Fund for Economic Uncertainties	(104,807)	-	557,439	557,482	(43)	(0.0)	-	
Transfer to Other Funds	15,045	45,950	232,993	182,380	50,613	27.8	141,938	
Transfer to Revolving Fund	(32,398)	(17,674)	20,195	-	20,195	-	35,650	
Advance:								
State-County Property Tax Administration Program	-	-	-	-	-	-	-	
Social Welfare Federal Fund	22,410	(1,061)	19,246	-	19,246	-	(37,582)	
Tax Relief and Refund Account	(22,500)	(56,700)	-	-	-	-	-	
Counties for Social Welfare	664,880	560,974	103,906	29,626	74,280	250.7	60,539	
Total Nongovernmental	542,630	531,489	933,779	769,488	164,291	21.4	200,545	
Total Disbursements	\$ 4,225,719	\$ 3,795,857	\$ 91,506,554	\$ 92,237,001	\$ (730,447)	(0.8)	\$ 82,038,513	
TEMPORARY LOANS								
Special Fund for Economic Uncertainties	\$ -	\$ -	\$ -	\$ 1,302,023	\$ (1,302,023)	(100.0)	\$ -	
Other Internal Sources	-	-	-	129,088	(129,088)	(100.0)	-	
Revenue Anticipation Notes	(3,000,000)	(6,000,000)	-	-	-	-	-	
Net Increase / (Decrease) Loans	\$ (3,000,000)	\$ (6,000,000)	\$ -	\$ 1,431,111	\$ (1,431,111)	(100.0)	\$ -	

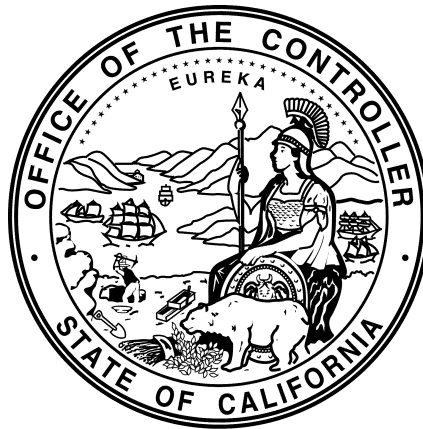
See notes on page 1.

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# **STATEMENT of GENERAL FUND CASH RECEIPTS and DISBURSEMENTS**

**October 2006**



**STEVE WESTLY**  
California State Controller

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**STEVE WESTLY**  
**California State Controller**

November 9, 2006

Users of the Statement of General Fund Cash Receipts and Disbursements:

Attached is the Statement of General Fund Cash Receipts and Disbursements for the period July 1, 2006 through October 31, 2006. This statement reflects the State of California's General Fund cash position and compares actual receipts and disbursements for the 2006-07 fiscal year to cash flow estimates prepared by the Department of Finance for the 2006-07 Budget Act. The statement is prepared in compliance with Provision 9 of Budget Act item 0840-001-0001.

These statements are also available at <http://www.sco.ca.gov/ard/cash/index.shtml>.

Any questions concerning this report may be directed to Michael Carter, Chief Operating Officer, at (916) 552-8080.

Sincerely,

Original Signed By:

STEVE WESTLY

**STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS**  
**A Comparison of Actual to 2006-07 Budget Act Estimates**  
**(Amounts in thousands)**

	July 1 through October 31				
	2006				2005
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
<b>GENERAL FUND BEGINNING CASH BALANCE</b>	<b>\$ 9,232,801</b>	<b>\$ 9,232,801</b>	<b>\$ -</b>	<b>-</b>	<b>\$ 6,436,788</b>
Add Receipts:					
Revenues	26,374,392	25,931,000	443,392	1.7	24,961,007
Nonrevenues	350,191	(315,469)	665,660	-	291,083
Total Receipts	26,724,583	25,615,531	1,109,052	4.3	25,252,090
Less Disbursements:					
State Operations	9,865,146	9,116,234	748,912	8.2	8,108,502
Local Assistance	30,741,030	30,892,122	(151,092)	(0.5)	28,199,009
Capital Outlay	1,625,248	1,662,911	(37,663)	(2.3)	367,623
Nongovernmental	108,649	25,970	82,679	318.4	(406,046)
Total Disbursements	42,340,073	41,697,237	642,836	1.5	36,269,088
Receipts Over / (Under) Disbursements	(15,615,490)	(16,081,706)	466,216	-	(11,016,998)
Net Increase / (Decrease) in Temporary Loans	6,382,689	6,848,905	(466,216)	(6.8)	4,580,210
<b>GENERAL FUND ENDING CASH BALANCE</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Special Fund for Economic Uncertainties (b)	-	-	-	-	-
<b>TOTAL CASH</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>-</b>	<b>\$ -</b>
<b>BORROWABLE RESOURCES</b>					
Available Borrowable Resources	\$ 16,364,401	\$ 14,751,653	\$ 1,612,748	10.9	\$ 11,476,822
Outstanding Loans (c)	6,382,689	6,848,905	(466,216)	(6.8)	4,580,210
Unused Borrowable Resources	\$ 9,981,712	\$ 7,902,748	\$ 2,078,964	26.3	\$ 6,896,612

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

- (a) A Statement of Estimated Cash Flow for the 2006-07 fiscal year prepared by the Department of Finance for the Budget Act of 2006. Any projections or estimates are set forth as such and not as representations of fact.
- (b) The Special Fund for Economic Uncertainties amount in the actual column does not include amounts in the Budget Stabilization Account.
- (c) Cumulative loan balance of \$6.4 billion is comprised of \$4.9 billion of internal borrowing and \$1.5 billion in external borrowing.
- (d) Negative balances are the result of repayments received that are greater than disbursements made.
- (e) Includes School Facility Aid Program that was previously displayed separately.

**SCHEDULE OF CASH RECEIPTS**

(Amounts in thousands)

Month of October		July 1 through October 31				
		2006				2005
2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
				Amount	%	
\$ 32,784	\$ 16,812	\$ 117,017	\$ 117,000	\$ 17	0.0	\$ 101,672
358,550	328,993	3,118,284	3,110,000	8,284	0.3	2,905,267
11,821	14,655	43,352	42,000	1,352	3.2	42,555
673	11,199	5,925	-	5,925	-	99,748
(257,025)	15,528	562,051	580,000	(17,949)	(3.1)	573,442
3,089,372	2,805,332	14,127,240	13,785,000	342,240	2.5	12,857,289
1,077,381	901,333	7,687,819	7,779,000	(91,181)	(1.2)	7,387,573
61,299	34,261	233,749	139,000	94,749	68.2	126,892
82,440	167,859	478,955	379,000	99,955	26.4	866,569
4,457,295	4,295,972	26,374,392	25,931,000	443,392	1.7	24,961,007
-	-	-	-	-	-	-
9,391	17,777	70,305	(454,806)	525,111	-	121,752
(314)	4,160	279,886	139,337	140,549	100.9	169,331
9,077	21,937	350,191	(315,469)	665,660	-	291,083
\$ 4,466,372	\$ 4,317,909	\$ 26,724,583	\$ 25,615,531	\$ 1,109,052	4.3	\$ 25,252,090

See notes on page 1.

**SCHEDULE OF CASH DISBURSEMENTS**

(Amounts in thousands)

	Month of October		July 1 through October 31					2005
			2006					
	2006	2005	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual	
					Amount	%		
STATE OPERATIONS (d)								
Legislative/Judicial/Executive	\$ 107,904	\$ 49,950	\$ 562,790	\$ 614,310	\$ (51,520)	(8.4)	\$ 530,862	
State and Consumer Services	15,587	35,777	215,767	201,376	14,391	7.1	182,033	
Business, Transportation and Housing	913	1,279	6,096	5,737	359	6.3	5,864	
Resources	127,064	57,663	490,044	395,994	94,050	23.8	375,116	
Environmental Protection Agency	7,146	6,471	17,575	17,217	358	2.1	18,281	
Health and Human Services:								
Health Services	1,346	27,195	151,721	125,329	26,392	21.1	159,719	
Mental Health Hospitals	76,175	53,892	307,692	370,330	(62,638)	(16.9)	257,915	
Other Health and Human Services	52,735	48,472	298,969	191,738	107,231	55.9	283,096	
Education:								
University of California	320,145	261,969	1,100,289	1,129,948	(29,659)	(2.6)	1,048,682	
State Universities and Colleges	249,706	162,583	1,351,748	1,020,183	331,565	32.5	891,092	
Other Education	22,078	3,293	78,334	64,502	13,832	21.4	71,679	
Dept. of Corrections and Rehabilitation	675,302	563,918	2,679,903	2,439,879	240,024	9.8	2,345,035	
General Government	114,837	90,255	972,323	514,369	457,954	89.0	431,854	
Public Employees Retirement								
System	243,365	269,858	288,802	222,658	66,144	29.7	274,840	
Debt Service	480,873	477,707	1,342,327	1,801,435	(459,108)	(25.5)	1,224,568	
Interest on Loans	(8,038)	4,448	766	1,229	(463)	(37.7)	7,866	
Total State Operations	2,487,138	2,114,730	9,865,146	9,116,234	748,912	8.2	8,108,502	
LOCAL ASSISTANCE (d)								
Public Schools - K-12	4,541,811	2,667,072	14,761,857	13,848,561	913,296	6.6	11,924,145	
Community Colleges	378,852	321,782	1,814,140	1,816,212	(2,072)	(0.1)	1,436,798	
Contributions to State Teachers' Retirement System	119,480	117,261	717,871	778,483	(60,612)	-	846,540	
Other Education (e)	254,750	(34,543)	1,299,804	1,192,164	107,640	9.0	1,110,762	
Dept. of Corrections and Rehabilitation	16,275	493	63,767	15,379	48,388	314.6	48,248	
Dept. of Alcohol and Drug Program	19,275	1,010	162,293	222,045	(59,752)	(26.9)	128,789	
Dept. of Health Services:								
Medical Assistance Program	1,100,759	970,164	4,573,412	4,779,942	(206,530)	(4.3)	4,289,250	
Other Health Services	20,158	30,398	247,723	198,135	49,588	25.0	229,412	
Dept. of Developmental Services	335,298	340,467	1,156,583	1,447,906	(291,323)	(20.1)	991,297	
Dept. of Mental Health	233,721	280,744	237,891	646,606	(408,715)	(63.2)	495,661	
Dept. of Social Services:								
SSI/SSP/IHSS	440,542	361,034	2,054,707	2,010,171	44,536	2.2	2,065,540	
CalWORKs	220,429	371,251	1,364,198	1,433,003	(68,805)	(4.8)	1,589,601	
Other Social Services	111,975	120,165	382,435	477,677	(95,242)	(19.9)	454,981	
Tax Relief	16,206	16,954	171,675	114,855	56,820	49.5	166,359	
Other Local Assistance	238,077	127,250	1,732,674	1,910,983	(178,309)	(9.3)	2,421,626	
Total Local Assistance	8,047,608	5,691,502	30,741,030	30,892,122	(151,092)	(0.5)	28,199,009	

See notes on page 1.

(Continued)

**SCHEDULE OF CASH DISBURSEMENTS (Continued)**

(Amounts in thousands)

	Month of October		July 1 through October 31				2005
			2006		Actual Over or (Under) Estimate		
	2006	2005	Actual	Estimate (a)	Amount	%	Actual
CAPITAL OUTLAY	344,502	361,555	1,625,248	1,662,911	(37,663)	(2.3)	367,623
NONGOVERNMENTAL (d)							
Transfer to Special Fund for Economic Uncertainties	-	-	-	-	-	-	-
Transfer to Budget Stabilization Account	-	-	471,770	471,770	-	-	-
Transfer to Other Funds	71,958	63,234	244,146	69,600	174,546	-	76,539
Transfer to Revolving Fund	(46,074)	297	21,300	-	21,300	-	50,295
Advance:							
State-County Property Tax Administration Program	-	-	-	-	-	-	-
Social Welfare Federal Fund	34,723	8,033	35,313	-	35,313	-	28,094
Tax Relief and Refund Account	1,000	-	1,000	-	1,000	-	-
Counties for Social Welfare	-	-	(664,880)	(515,400)	(149,480)	-	(560,974)
Total Nongovernmental	61,607	71,564	108,649	25,970	82,679	318.4	(406,046)
Total Disbursements	\$ 10,940,855	\$ 8,239,351	\$ 42,340,073	\$ 41,697,237	\$ 642,836	1.5	\$ 36,269,088
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	\$ 1,295,007	\$ 85,773	\$ 1,295,007	\$ 1,295,007	\$ -	-	\$ 744,541
Budget Stabilization Account	471,770	-	471,770	471,770	-	-	-
Other Internal Sources	3,115,912	3,835,669	3,115,912	3,582,128	(466,216)	(13.0)	3,835,669
Revenue Anticipation Notes	1,500,000	-	1,500,000	1,500,000	-	-	-
Net Increase / (Decrease) Loans	\$ 6,382,689	\$ 3,921,442	\$ 6,382,689	\$ 6,848,905	\$ (466,216)	(6.8)	\$ 4,580,210

See notes on page 1.

(Concluded)

**COMPARATIVE STATEMENT OF REVENUES RECEIVED**  
**All Governmental Cost Funds**  
**(Amounts in thousands)**

	July 1 through October 31			
	General Fund		Special Funds	
	2006	2005	2006	2005
<b>MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:</b>				
Alcoholic Beverage Excise Taxes	\$ 117,017	\$ 101,672	\$ -	\$ -
Corporation Tax	3,118,284	2,905,267	-	-
Cigarette Tax	43,352	42,555	363,389	358,340
Estate, Inheritance, and Gift Tax	5,925	99,748	-	-
Insurance Companies Tax	562,051	573,442	-	-
Motor Vehicle Fuel Tax:				
Gasoline Tax	-	-	972,257	981,368
Diesel & Liquid Petroleum Gas	-	-	199,431	192,462
Jet Fuel Tax	-	-	1,045	(7,238)
Vehicle License Fees	-	-	783,408	760,270
Motor Vehicle Registration and Other Fees	-	-	951,423	933,820
Personal Income Tax	14,127,240	12,857,289	248,456	226,695
Retail Sales and Use Taxes	7,687,819	7,387,573	2,268,528	2,032,184
Pooled Money Investment Interest	233,749	126,892	151	47
<b>Total Major Taxes, Licenses, and Investment Income</b>	<b>25,895,437</b>	<b>24,094,438</b>	<b>5,788,088</b>	<b>5,477,948</b>
<b>NOT OTHERWISE CLASSIFIED:</b>				
Alcoholic Beverage License Fee	2,087	1,411	16,089	12,756
Electrical Energy Tax	-	-	172,574	135,941
Private Rail Car Tax	46	(2)	-	-
Penalties on Traffic Violations	-	-	24,386	22,795
Health Care Receipts	1,033	5,344	-	-
Revenues from State Lands	115,195	64,203	-	21,430
Abandoned Property	(54,402)	(12,111)	-	-
Trial Court Revenues	21,771	19,687	427,573	398,207
Horse Racing Fees	731	685	11,301	11,833
Miscellaneous	392,494	787,352	2,351,898	2,637,469
<b>Not Otherwise Classified</b>	<b>478,955</b>	<b>866,569</b>	<b>3,003,821</b>	<b>3,240,431</b>
<b>Total Revenues, All Governmental Cost Funds</b>	<b>\$ 26,374,392</b>	<b>\$ 24,961,007</b>	<b>\$ 8,791,909</b>	<b>\$ 8,718,379</b>

See notes on page 1.



**APPENDIX B**  
**THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF**  
**CALIFORNIA,**  
**THE PROGRAM AND THE 1943 FUND**

This APPENDIX B includes information about the Department, its Program, the 1943 Fund (including audited financial statements) and the Department's allocation of receipts from Contracts of Purchase, including Excess Revenues. Capitalized items not defined herein shall have the meanings ascribed to them in the Official Statement.

**THE DEPARTMENT**

**General**

In 1921, the California Legislature (the "Legislature") created the Veterans' Welfare Board and the Program. The Department of Veterans Affairs became the successor to the Veterans' Welfare Board under the Farm and Home Purchase Act of 1943 (the "1943 Act"). The Department is a subdivision of the State and constitutes a public corporation. One of the Department's basic objectives is to provide eligible veterans the opportunity to acquire homes with long-term low-interest financing provided under the Program.

The California Veterans Board ("Board") advises the Department on policies for all operational matters. The Board is composed of seven members appointed by the Governor, subject to Senate confirmation, for respective terms of four years except that the member of the Board who is a resident of a California veterans home shall have a two year term. All of the members of the Board must be veterans, one member must be retired from the active or reserve forces of the United States military service, one member must have substantial training or professional expertise in mortgage lending and real estate finance, one member must have substantial training or professional expertise in geriatrics, gerontology, or long-term care, and one member must be a resident of one of the California veterans homes run by the Department established for qualified aged and disabled veterans and their spouses. There is presently one vacancy on the Board.

There are four principal divisions within the Department: the Division of Veterans Services, the Division of Administration, the Veterans' Home Division and the Division of Farm and Home Purchases. The Program is administered by the Division of Farm and Home Purchases with support from the Division of Administration and other Department support units. See "THE PROGRAM" herein. The Program and the Department have been the subject of external reviews as described herein. See "THE PROGRAM – External Review of the Program" herein.

**Administration**

In addition to its headquarters in Sacramento, California, the Division of Farm and Home Purchases maintains field offices located throughout the State. These local offices, in addition to providing information to all veterans concerning the Program, are responsible for Contract of Purchase originations and the initial collection and evaluation of data regarding applicants for the Program and the properties to be acquired under the Program. A Contract of Purchase creates an installment land sale contract between the Department and the veteran which is analogous to a loan from the Department to the veteran, as such Contracts of Purchase are sometimes referred to as loans herein. Contracts of Purchase and the Program

are discussed under “THE PROGRAM” herein. These origination, collection and evaluation processes include examinations as to the qualification of veterans to participate in the Program, a credit analysis for each applicant, ordering appraisals of properties and the initial processing of the veterans’ applications for Contracts of Purchase. Field offices handle the complete Contract of Purchase processing for home improvement Contracts of Purchase and construction Contracts of Purchase and also handle overflow from the Sacramento headquarters when volume is high.

Final processing and servicing of the Contracts of Purchase are performed by the Department at its Sacramento, California, headquarters except processing of home improvement Contracts of Purchase, construction Contracts of Purchase and certain overflow volume which are handled by the Department’s field offices. Processing and servicing of Contracts of Purchase entails Contract of Purchase accounting, insurance and property damage claims adjustment and services, alterations and contract performance services. The Department allows certain specially-trained and certified mortgage brokers to originate Contracts of Purchase. All Contracts of Purchase are serviced by the Department. The Department uses an integrated loan processing and financial information system (“Mitas”) for origination and servicing of all Contracts of Purchase. General administration of the Program, including fiscal, legal, personnel and other administrative functions, is also performed at the Department’s headquarters. As of September 30, 2006, the Department employed approximately 110 persons in support of the Program.

The Secretary and other senior staff personnel of the Department principally responsible for the administration of the Program are listed below. The Secretary is appointed by the Governor of the State, serves at the pleasure of the Governor and must be a veteran.

*Thomas Johnson, FACHE*  
*Secretary since February 2004*

A Vietnam Era Veteran with more than 35 years in healthcare management experience, Mr. Johnson is a graduate of the University of Minnesota and holds a Masters Degree in public health from the University of California, Los Angeles. His knowledge of healthcare finance and management began with his service in the Medical Service Corps branch of the United States Army. He managed a 600-bed hospital and acted as commanding officer for Army patients dislocated from their units in Vietnam. Upon his return from overseas deployment and discharge from the Army, Mr. Johnson served for 31 years as a hospital administrator in Tulare County, first at Tulare District Hospital and later at Kaweah Delta District Hospital in Visalia. Since 2001, Mr. Johnson has served as a consultant to The California Endowment and to several health care organizations. Mr. Johnson is a Life Fellow with the American College of Healthcare Executives (FACHE) and is the board chair of the California Institute for Nursing and Healthcare. An active member in his community, Mr. Johnson has been involved with a great variety of local, state and federal groups.

*Roger L. Brautigan*  
*Undersecretary since June 2004*

Mr. Brautigan is a 33-year veteran of the U.S. Army, achieving the rank of Major General while serving in a variety of active and reserve command and staff positions in the United States, Vietnam and Germany. His command assignments ranged from Platoon

leader to both company and battalion level commands. Most recently he served as deputy commanding general and chief of staff, I Corps and Fort Lewis in Fort Lewis, Washington. Mr. Brautigan holds a Bachelor of Science degree from the University of Arizona at Tucson and a Master's degree from the University of the Pacific at Stockton, California. He is a graduate of the Armor, Infantry, and Adjutant General Officer Advanced Courses, Army Command and General Staff College, and the Army War College. Mr. Brautigan's military awards and decorations include the Defense Distinguished Service Medal, the Distinguished Service Medal, the Legion of Merit (with oak leaf cluster), the Bronze Star Medal, the Defense Meritorious Service Medal, the Meritorious Service Medal (with 3 oak leaf clusters), the Army Commendation Medal (with 3 oak leaf clusters), the Army Achievement Medal (with oak leaf cluster), various service and unit awards, and the Army General Staff Identification Badge.

*John Peter "J. P." Tremblay*

*Deputy Secretary of Communications and Legislation since June 2006*

Mr. Tremblay has more than 23 years of experience in the news media, and governmental and political communications. He was appointed as Deputy Secretary for Veterans Affairs by Governor Schwarzenegger in June 2006. Prior to his appointment he was appointed by the Governor as the Assistant Secretary for the Office of Public and Employee Communications for the Department of Corrections and Rehabilitation in July 2005. Mr. Tremblay was appointed Assistant Secretary of the Youth and Adult Correctional Agency in March 1994 by Governor Wilson after serving as his Deputy Director of Communications in 1993. Before joining the Wilson administration, Mr. Tremblay was a political and Capitol Bureau Chief for the Sacramento Union from 1989 to 1993. Before moving to Sacramento, Mr. Tremblay was a business and government reporter for the Leader Newspaper Group in Los Angeles, California. Mr. Tremblay received his Bachelor of Arts degree from California State University, Northridge.

*Sheryl A. Schmidt*

*Deputy Secretary since November 1996*

After leaving the accounting firm of Touche Ross (now known as Deloitte & Touche LLP) in 1987, Deputy Secretary Schmidt began her state career at the State Controller's Office as a Certified Public Accountant (CPA). In 1995, she accepted the newly created position of Chief of Audits at the Department and developed the Internal Audit Division. In 1996, the Governor of California appointed Ms. Schmidt, a United States Air Force veteran, as the Deputy Secretary of Women Veterans Affairs. Ms. Schmidt holds a Bachelor's degree in management from St. Leo's College in Florida, a Master's of Business Administration (MBA) from California State University, Sacramento, and a CPA license from the California State Board of Accountancy.

*John Hanretty*

*Director of Operations since August 2004; Acting Chief, Bond Finance Division*

Mr. Hanretty is a United States Air Force, Vietnam-era veteran who graduated from California State University, Sacramento in 1975 with a degree in Government. After graduation, he worked for eight years in the California Department of Health Services regulating Prepaid Health Plans for Medicaid clients. He then spent twelve years in management positions with private health maintenance organizations in Arizona and

California rising to the level of Chief Executive Officer. His responsibilities included sales, medical management, provider staffing, member services, contracting, financial accounting and budgeting. He returned to State government service in 1994 as a Budget Manager. Duties of the Chief, Bond Finance Division are performed by Mr. Hanretty. Mr. Hanretty served as the Budget Officer for the Department from August 1998 until September 1999, was Chief, Administrative Services Division from September 1999 until July 2004, and was appointed Director of Operations in August 2004.

*Robert Wilson*

*Deputy Secretary and Chief Counsel of Legal Affairs since May 2005*

Robert D. Wilson received a Bachelor of Arts degree from the University of Northern Colorado in 1973 with a major in Psychology and a minor in Economics. Following his graduation, he entered the United States Marine Corps and served as a pilot (A-4M). After his discharge from the Corps, he flew commercially for several years. Mr. Wilson then entered law school at the University of Kansas and obtained his J.D. degree in 1988. He has co-authored articles on the good faith obligations imposed upon financial institutions when calling demand notes and judicial jurisdiction over foreign defendants. He practiced law as a litigator in the private sector for approximately eleven years before accepting employment with the Office of the California Attorney General. During his tenure at the Attorney General's Office, Mr. Wilson twice received Attorney General Awards for work on complex prison and governmental law cases.

*Debra Lehr*

*Chief, Farm and Home Purchases Division since July 2003*

Ms. Lehr brings more than 30 years of Program experience to the position of Division Chief. Her responsibilities have included loan origination, appraisal, underwriting, legal, marketing, collections and foreclosure functions. Since 1995, she has held the positions of Foreclosure/REO Unit Manager, Loan Servicing Operations Manager and Assistant Division Chief with oversight of all loan-servicing functions, and was responsible for the successful centralization and reengineering of the Program's delinquent account, foreclosure and REO processes.

## **THE PROGRAM**

### **General**

The Department began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the Legislature of the Veterans Farm and Home Purchase Act of 1921. In 1943, the Legislature enacted the 1943 Act which modified the Program to meet new needs of veterans. The 1943 Act was superseded by the Veterans Farm and Home Purchase Act of 1974 (the "1974 Act") which again modified the Program. The 1943 Act established the 1943 Fund in the State Treasury, which is the principal fund utilized by the Program.

Since its inception, the Program has assisted approximately 418,268 veterans to purchase farms and homes throughout the State through long-term housing and farm loans. The sales of revenue bonds (including Revenue Bonds) and Veterans G.O. Bonds, combined with surplus revenues under the Program not needed at any given time to meet the then-current bond retirement schedules and operating costs, have financed the purchase of

farms and homes since the Program's inception. As of June 30, 2006, there were approximately 14,996 Contracts of Purchase outstanding with a remaining principal balance of approximately \$1.5 billion. As of June 30, 2006 the Department had approximately 457 pending applications for Contracts of Purchase in the total principal amount of approximately \$124,702,000. See EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase" and "– Amounts Expected to be Available to Finance Contracts of Purchase and Related Investments" for information regarding existing Contracts of Purchase and moneys available to finance additional Contracts of Purchase.

The description of the Program under this heading is a description of the Program as it currently exists under the Veterans Code and the Department's implementation thereof. The Veterans Code and the Department's implementation of the Program are subject to change. The Program is also subject to the Federal Tax Code, as noted below.

### **Qualifying Veteran Status**

*Veterans Code.* A veteran must meet qualifications established under the Veterans Code in order to participate in the Program. The qualifications specified in the Veterans Code are subject to change by the Legislature. The Veterans Code allows the Department to finance Contracts of Purchase for:

(a) veterans who have served, generally, at least ninety days on active duty in the Armed Forces of the United States, unless sooner discharged because of a service-connected disability, and have received an honorable discharge or been released from active duty under honorable conditions during one of the following periods:

(i) April 6, 1917 through November 11, 1918; December 7, 1941 through December 31, 1946; or June 27, 1950 through January 31, 1955 (such veterans are referred to as "Earlier War Veterans");

(ii) February 28, 1961 through August 4, 1964 if the veteran served in the Republic of Vietnam during that period ("Early Vietnam Veterans"); or August 5, 1964 through May 7, 1975 (all veterans referred to in this clause (ii) are "Vietnam Era Veterans"); or

(iii) on or after August 2, 1990, through a date as yet to be determined by the President of the United States; at any time in Somalia, or in direct support of the troops in Somalia, during Operation Restore Hope; or at any time in an expedition or campaign for which a medal was authorized by the United States Government such as the Armed Forces Expeditionary and Vietnam Service Medals (such veterans are referred to as "Recent War Veterans");

(b) any member of the reserves or National Guard who is called to, and released from, active duty or active service, regardless of the number of days served, during any period when a presidential executive order specifies the United States is engaged in combat or homeland defense, and who received an honorable discharge or was released from active duty or active service under honorable conditions;

(c) any person who qualifies under the Federal Tax Code for financing from Revenue Bonds or unrestricted funds of the Department and who served in the active military, naval, or air service for a period of not less than ninety consecutive days and who received an honorable discharge or was released from active duty under honorable conditions (such veterans are referred to as “Peacetime Veterans”); and

(d) any person who qualifies under the Federal Tax Code for financing from Revenue Bonds or unrestricted funds of the Department and is at the time of application for benefits a member of the California National Guard or a reserve component of any branch of the United States Armed Forces who has enlisted or been commissioned in that service for a period of not less than six years and has completed a minimum of one year of satisfactory service.

Amendments to the Veterans Code effective January 1, 1998 added Early Vietnam Veterans and Peacetime Veterans and amendments effective January 1, 2005 added those persons described in paragraphs (b) and (d) above as veterans eligible to receive Contracts of Purchase. These amendments, together with various financial and programmatic changes implemented by the Department, have significantly increased the universe of veterans eligible to receive Contracts of Purchase from the Department. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA.” At this time the Department is not using unrestricted funds of the Department to finance Contracts of Purchase for those veterans described in paragraph (d) above.

*Federal Tax Code.* In order to determine which Department moneys can be used to finance Contracts of Purchase, the Department must also take into account the requirements of Federal law set forth in the Federal Tax Code, which limits the universe of veterans eligible to receive Contracts of Purchase financed from certain sources. See APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS.” Based on current Federal Tax Code, the Department’s lendable moneys are separated into three classes:

(a) “Unrestricted Moneys” (derived from certain moneys in the 1943 Fund, certain proceeds of Pre-Ullman (as defined below) Revenue Bonds and Veterans G.O. Bonds, and certain future issues of taxable bonds, if any), which can finance Contracts of Purchase for those veterans who qualify under the applicable provisions of the Veterans Code. The QMB Loan Eligibility Requirements, defined below, do not apply to Contracts of Purchase financed by Unrestricted Moneys. The Department has implemented a policy (which is subject to change) to make Unrestricted Moneys available for Earlier War Veterans, Vietnam Era Veterans, Recent War Veterans and Peacetime Veterans. (“Pre-Ullman” refers to the period prior to enactment of Federal Tax Code programmatic restrictions on the use of proceeds of tax-exempt bonds to finance mortgage loans);

(b) “QVMB Proceeds” (derived exclusively from proceeds of Veterans G.O. Bonds), which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code; (ii) served on active duty prior to January 1, 1977; and (iii) was released from active duty fewer than 30 years before receiving such financing. The last date of veteran eligibility under clause (iii) is December 31, 2036 for a veteran with 30 years of continuous service after December 31, 1976. The

QMB Loan Eligibility Requirements (defined below) do not apply to Contracts of Purchase financed by moneys derived exclusively from proceeds of Veterans G.O. Bonds. These proceeds can finance Contracts of Purchase for Earlier War Veterans and Vietnam Era Veterans; and

(c) “Qualified Mortgage Bond Proceeds” (derived principally from Revenue Bond proceeds other than Pre-Ullman Revenue Bond proceeds), which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, and (ii) satisfies certain requirements imposed by the Federal Tax Code principally limiting the family income of applicants and the property purchase price, and, subject to certain exceptions, requiring that the veteran not have had a present ownership interest in his principal residence in the three years prior to obtaining such financing (“QMB Loan Eligibility Requirements”).

### **Allocation of Lendable Moneys**

For veterans who qualify for Contracts of Purchase from two or more of the above-described financing sources, the Department may select the source of funds to be used in its sole discretion. The Department’s goal is to maximize the availability of Program benefits. Current policy is that all veterans who qualify for QVMB Proceeds are funded from that source and all other eligible veterans are funded from Unrestricted Moneys. Available Qualified Mortgage Bond Proceeds or recycling funds are used for National Guard or reserves members who are only eligible for those funds under State law.

### **Administration of the Farm and Home Purchase Program**

The Department finances new and existing single-family homes, farms and mobile homes located in the State by acquiring the property selected by a veteran under a Contract of Purchase. The Department also finances home improvements with respect to properties covered by existing Contracts of Purchase, subject to applicable restrictions of the Federal Tax Code. The amount the Department finances is reflected in the Contract of Purchase as the “purchase price.” See “THE PROGRAM – Contracts of Purchase” in this APPENDIX B.

Under the Veterans Code, the maximum purchase price to the Department of an existing home or the sum to be expended by the Department pursuant to a Contract of Purchase for a home to be constructed shall not exceed (i) 125% of the current maximum Fannie Mae loan limit for a single-family home, which is annually set by Fannie Mae (as of January 1, 2006 the Fannie Mae loan limit is \$417,000; therefore, the maximum purchase price to the Department is \$521,250) or (ii) 150% of such Fannie Mae limit for farms (except that (a) the limitation with respect to mobile homes located on or to be located on a leased or rented site in a mobile home park is \$125,000 and (b) the maximum purchase price for any home may be increased by an additional \$5,000 for certain purposes). The Legislature has periodically made changes in the maximum amount that may be financed under a Contract of Purchase. The Federal Tax Code imposes maximum purchase prices on properties that are the subject of Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The Federal Tax Code permits such maximums to be adjusted periodically. No Federal Tax Code purchase price limits apply to Contracts of Purchase financed from Unrestricted Moneys or QVMB Proceeds. These Federal Tax Code requirements vary depending upon where the property is located, if it is in a targeted or non-targeted area, and whether it is a new or existing home. The maximum purchase price under the Program is, therefore, the Veterans

Code maximum amount or, if the Contract of Purchase is being financed by Qualified Mortgage Bond Proceeds, the lesser of the Veterans Code maximum amount or the maximum amount under applicable provisions of the Federal Tax Code.

The Veterans Code permits the Department to finance permanent home and property improvements for veterans with no existing financing or subordinate to existing financing (provided by lenders other than the Department) through the use of a deed of trust as the financing instrument. At present the Department has not implemented a program to fund loans subordinate to existing debt.

The Department also limits availability of financing to veterans on the basis of their personal credit status. The Department's current lending criteria and procedures for all Contracts of Purchase originated with LTVs in excess of 80% conform to those of the United States Department of Veterans Affairs (the "USDVA") for participation in the USDVA guaranty program. Loans with USDVA guarantees require certain additional documentation. See "- Loan Insurance – USDVA Guaranty Program" herein. The lending criteria and procedures for Contracts of Purchase originated with loan-to-value ratios ("LTVs") of 80% or less are less stringent than the USDVA guaranty program requirements.

Although the Veterans Code does not impose maximum income limits, the Federal Tax Code imposes maximum income limits applicable only to veterans obtaining Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The income limits vary by statistical area and family size. No maximum income limits apply to veterans obtaining Contracts of Purchase financed by Unrestricted Moneys or QVMB Proceeds.

Any veteran who qualifies under the Veterans Code and the Federal Tax Code may be granted a subsequent Contract of Purchase so long as any previous Contract of Purchase has been paid in full or the veteran lost his or her interest in the previous Contract of Purchase through divorce or dissolution of marriage.

### **Contracts of Purchase**

*General.* Pursuant to the Program, the Department and the veteran may enter into a Contract of Purchase for a farm, home or mobile home. Under a Contract of Purchase, the veteran has the benefits of ownership as the equitable owner of the property, but title to the property and improvements thereon is held by the Department as the legal owner until the final principal payment is made. Property sold under a Contract of Purchase may not be transferred, assigned, encumbered, leased, let or sublet without the written consent of the Department. Any such permitted encumbrance must be junior or secondary to the Department's interest in the property.

Before 1998, Contracts of Purchase were not insured or guaranteed by the Federal Housing Administration, the USDVA, Rural Development (formerly, Farmers' Home Administration), or any private primary mortgage insurer. In 1998, the Department was approved by the USDVA as an originator of loans eligible to receive a guaranty from the USDVA. In addition to the USDVA guaranty, the Department has secured primary mortgage insurance for certain prior and all future Contracts of Purchase not guaranteed by the USDVA with LTVs above 80% from Radian Guaranty Inc. ("Radian"). See "THE PROGRAM – Loan Insurance – Primary Mortgage Insurance." Certain Contracts of Purchase are not the subject of loan insurance or guarantees. See EXHIBIT 2 to this



## APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase.”

The terms of the Contracts of Purchase funded by Unrestricted Moneys, QVMB Proceeds or Qualified Mortgage Bond Proceeds are substantially identical, except for interest rates on Contracts of Purchase originated after January 1, 1999 and Federal Tax Code-mandated differences in Contracts of Purchase financed with Qualified Mortgage Bond Proceeds. Two ways in which Contracts of Purchase funded with Qualified Mortgage Bond Proceeds are different are that such Contracts of Purchase: (a) have more restrictions on the right of a purchaser to assume the obligations under the Contract of Purchase than do Contracts of Purchase financed by Unrestricted Moneys or QVMB Proceeds and (b) Qualified Mortgage Bond Proceeds may be subject to Federal Tax Code-mandated recapture provisions. In addition, the Federal Tax Code contains the QMB Loan Eligibility Requirements, which are numerous loan eligibility restrictions on borrowers receiving financing from proceeds such as Qualified Mortgage Bond Proceeds. These restrictions require, among other things, and subject to certain exceptions contained in the Federal Tax Code, that borrowers (i) not have had a present ownership interest in their principal residence during the three-year period preceding the date of financing, (ii) are eligible to finance the purchase of residences with purchase prices not in excess of limits stated in the Federal Tax Code, (iii) must not have family incomes in excess of limits stated in the Federal Tax Code, (iv) may not use the proceeds of the financing to refinance an existing mortgage loan and (v) may use the proceeds of the financing only to finance one-family or one-to-four family dwelling units meeting certain criteria. The Federal Tax Code includes certain procedures that an issuer of Qualified Mortgage Bonds may undertake to satisfy these requirements, but requires that 95% or more of the proceeds of the bond issue be used in full compliance with the loan eligibility restrictions.

Since the number and aggregate principal balance of Contracts of Purchase relating to farms Contracts of Purchase financed pursuant to the 1943 Act are statistically insignificant, the discussion below is limited to Contracts of Purchase financed under the 1974 Act for homes, excluding farms, unless otherwise indicated. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase.”

Many factors affect the ability or willingness of homebuyers to make mortgage loan payments and of potential homebuyers to borrow money to purchase homes. These factors include, among others, general economic conditions, interest rates and costs of living.

*Mobile Homes.* Generally, Contracts of Purchase to finance the purchase of mobile homes where the Department obtains title to the land (mobile homes not in mobile home parks) are treated substantially the same as Contracts of Purchase to finance the purchase of single family residences. For Contracts of Purchase to finance mobile homes where the Department does not obtain title to the land (mobile homes in mobile home parks), the Department originates such Contracts of Purchase only where the mobile home is in a qualified mobile home park. Such Contracts of Purchase have terms of less than thirty years and interest rates which are one percent higher than the interest rate for Contracts of Purchase to finance single family homes.

*Origination.* The Veterans Code, in certain cases, requires the veteran to make an initial payment of at least 2% of either the purchase price or the market value of the property, whichever is less. The Veterans Code permits veterans eligible for a full USDVA guaranty, subject to the Department's underwriting criteria, to qualify for a loan requiring no down payment. The balance of the purchase price, including USDVA guaranty fees, may be amortized over a period fixed by the Department, not exceeding 30 years and 32 days for all Contracts of Purchase guaranteed by USDVA, and 40 years for any other Contracts of Purchase. Pursuant to its policy, the Department issues all new Contracts of Purchase, except for Contracts of Purchase for mobile homes, for terms of 30 years unless a shorter term is requested. Existing Contracts of Purchase are occasionally extended beyond 30 years in cases of extreme financial hardship. Recent legislation requires certain extensions of loan terms. See "- Recent Legislative Changes to the Program" herein.

In addition to the initial payment, if any, referred to in the prior paragraph, a Loan Origination Fee ("LOF") of 1% of the loan amount is collected at close of escrow on all contracts issued after January 1, 1999. The LOF must be paid in escrow by the buyer or seller. If the loan application is submitted through an approved mortgage broker, the LOF is paid directly to the mortgage broker through the escrow. Otherwise, the LOF is retained by the Department.

Contracts of Purchase are originated by the Department's field offices and by mortgage brokers certified by the Department to originate loans. After a preliminary screening in the field offices, applications are forwarded to a centralized underwriting unit in Sacramento, California for processing. The field offices handle overflow loan processing from Sacramento, California and handle all processing for home improvement Contracts of Purchase and construction Contracts of Purchase. The mortgage brokers deal directly with the office that is processing the loan. An appraisal fee of \$350 to \$450 is paid directly to the appraiser by the Department or applicant upon completion of the assignment. In rare cases, where the appraisal is performed by a Department employee, the fee is retained by the Department.

*Recent Legislative Changes Affecting the Program.* Effective January 1, 2006 the maximum purchase price for Contracts of Purchase was increased from the annually adjusted Fannie Mae loan limit for single-family homes loan to 125% of such Fannie Mae loan limit.

On September 22, 2005 Governor Schwarzenegger signed into law, effective January 1, 2006, California Assembly Bill 306, The California Military Families Financial Relief Act ("AB 306"). AB 306 provides that members of the United States Military Reserves or the California National Guard called to active duty as part of the Iraq and Afghanistan conflicts may defer payments on obligations secured by mortgages and certain other obligations, including Contracts of Purchase, for the lesser of (i) 180 days or (ii) the period of active duty plus 60 calendar days. AB 306 requires that reservists desiring to take advantage of such deferments provide notice to their lender and meet certain income requirements. AB 306 also requires lenders, such as the Department, to extend the term of loans subject to deferment by the length of the deferral and prohibits foreclosure or repossession of property during a deferment period.

Under the Program, deferrals required by AB 306 are accounted for by the Department by creating a deferred balance on the loan account. Any loan payments received by the Department in excess of amounts due on such loans are applied to the deferred loan - balance. The Department anticipates that few loans affected by AB 306 will be paid in full through regular amortization and that most will be prepaid prior to the end of the term, making an extension of the loan term unnecessary. If a Contract of Purchase affected by AB 306 is covered by a USDVA guaranty, the Department will request the USDVA's approval to extend the loan term, if necessary. To date, the Department has received less than thirty notices from reservists requesting AB 306 deferrals and there has been no material impact on the 1943 Fund. See "- Delinquencies and Cancellations" herein.

*Home Improvement Contracts of Purchase.* The Veterans Code permits the Department to finance permanent home and property improvements. Currently, when a home improvement Contract of Purchase is approved, total financing, including the balance of the original Contract of Purchase, the amount of the improvement Contract of Purchase, and any other encumbrances, cannot exceed 90% of the improved market value of the property. Typically this total LTV is much lower than 90%. Except in the case of hardship, improvement loans are not approved for veterans who have had significant delinquencies in the 12 months immediately preceding the application. Funds are either disbursed by the Department directly to the contractors (or vendors) as the improvements are completed or veterans can be reimbursed for actual construction costs. For a home improvement loan subordinate to an existing Contract of Purchase, a separate Contract of Purchase covering only the improvements is executed, bearing interest at the same rate as the veteran's existing Contract of Purchase on home improvement loans made prior to January 1, 2005, or at current Department rates on home improvement loans made after January 1, 2005. The new Contract of Purchase is payable over a term up to 25 years. Generally, the time from the inception of the original Contract of Purchase through the pay-off of the improvement Contract of Purchase does not exceed 40 years. A LOF of 1.5% of the home improvement Contract of Purchase amount is required to be paid by the veteran. The maximum home improvement loan for veterans funded with Qualified Mortgage Bond Proceeds is \$15,000 over the term of the original Contract of Purchase. Home improvement loans funded with Unrestricted Moneys or QVMB Proceeds are available up to a maximum of \$150,000. Subsequent home improvement Contracts of Purchase may be granted, if funds are available, so long as there is only one home improvement Contract of Purchase to any veteran outstanding at any time. Currently, less than one percent of the total principal balance of all Contracts of Purchase is derived from home improvement loans.

*Construction Contracts of Purchase.* Contracts of Purchase for the purchase of a building site and construction of a home are available. Qualifying sites include undeveloped sites/acreage, lots in subdivision developments and sites in non-profit self help developments. Mobile homes in parks do not qualify. Construction of the improvements must be performed by a contractor licensed in California. The Department does not submit for USDVA guaranty Contracts of Purchase which finance home construction, however such Contracts of Purchase are insured by Radian if originated with LTVs of 80% or greater.

The history of the Department's originations of Contracts of Purchase is set forth in EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience."

*Servicing.* All Contracts of Purchase are serviced by the Department. Late penalty charges are applied to Contracts of Purchase that have a remaining amount due of \$25 or more at the close of any account month. A \$10 late penalty charge is imposed on Contracts of Purchase originated before October 1984. Contracts of Purchase originated during and after October 1984 are subject to a late penalty charge of 4% of the principal and interest portion of the installment, consistent with penalties authorized by USDVA.

The Department may, in any individual case and for good cause, permit the postponement from time to time, and upon such terms as it deems proper, of the payment of the whole or any part of any installment. Contracts of Purchase may also have terms in excess of 30 years if home improvement loans have been obtained, as discussed above, or under certain hardship conditions and/or active service periods. The terms of Contracts of Purchase guaranteed by USDVA, however, cannot exceed 30 years and 32 days, unless the USDVA, in its sole discretion, approves such extension.

*Prepayment Penalties.* There are no prepayment penalties on any Contracts of Purchase. The Department's actual past prepayment experience for existing Contracts of Purchase is set forth in EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience."

*Delinquencies and Cancellations.* The Department's policies regarding delinquencies and cancellations conform to Radian and USDVA loan guaranty program requirements. If a veteran fails to comply with any of the terms of a Contract of Purchase, to facilitate resale the Department may cancel the Contract of Purchase and be released from all obligations, at law or in equity. In such event, the veteran's rights under the Contract of Purchase may be forfeited and all payments made by the veteran prior to termination of the Contract of Purchase would be deemed to be rental paid for occupancy. Upon such forfeiture, the Department takes possession of the property covered by the Contract of Purchase and resells it.

If a veteran does not make a payment by the 16<sup>th</sup> day of the month in which the payment is due, the payment is considered "late." Mitas generates a reminder letter automatically if payment is not received by the 20<sup>th</sup> day of the month, which advises the veteran that payment has not been received. If payment is not received by the 30<sup>th</sup> day of the month, a second reminder letter is issued and the loan is considered "delinquent." If the account remains delinquent 60 days, a Notice of Intent to Cancel Contract ("NICC") is issued to notify the veteran that the Contract of Purchase may be canceled at the end of the 30-day notice period unless the account is brought current. Department personnel then initiate telephone contact with veterans with delinquent accounts. If the veteran has not paid by the 70<sup>th</sup> day of the delinquency, a letter is issued reminding the veteran that he or she must bring the account current within 30 days of the NICC date. A schedule for liquidation of delinquent payments satisfactory to the Department is arranged during this period; however, if the account remains delinquent after such 30-day period and no schedule for liquidation of

delinquent payments has been agreed upon, the Department may begin cancellation of the Contract of Purchase. If a schedule of liquidation has been agreed to with respect to a Contract of Purchase and the veteran makes all regularly scheduled payments and liquidation payments on a timely basis, the Department does not begin cancellation of the Contract of Purchase.

The Collections Unit at the Department's headquarters monitors the delinquency throughout this process, orders a title search to identify any junior lienholders and forwards the pertinent information to the Department's Foreclosure Unit for further precancellation processing in accordance with the California Code of Regulations, Title 12, Section 344, Military and Veterans Affairs. Junior lienholders are identified and sent notices giving them 30 days (40 days in the case of Federal tax liens) to protect their interest by beginning foreclosure proceedings. If the account is not brought current during such notice period to junior lienholders and no junior lienholder proceeds with a foreclosure action to protect its interest, the Department's Foreclosure Unit cancels the Contract of Purchase, and a Notice of Cancellation is mailed to the veteran and recorded. The Department's Foreclosure Unit then takes steps to evict occupants and clear any remaining liens. If judicial action is required, the case is referred to the Department's Law Division for additional processing.

After all remaining liens are removed and the property is vacant, the repossessed property is repaired and improved, if necessary and feasible, and is marketed through the Department's centralized repossession sales unit (Foreclosure Unit) through a Pre-Advertising Listing ("PAL") program. The PAL program involves listing a property for sale with a licensed real estate broker or agent, at an overall commission rate which typically does not exceed 6%. The Department is required to advertise and accept sealed offers during a 2-week period, and the property is sold to the highest acceptable bidder (best net return). If no acceptable bids are received, the property will continue to be marketed by the listing real estate agent until an acceptable offer is received and the property is sold.

See EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – CONTRACTS OF PURCHASE – Cancellations and Delinquencies" for additional information regarding the status of Contracts of Purchase.

*Interest Rates.* Contracts of Purchase originated prior to January 1, 1999 bear interest at a rate which is set by the Department and may be changed with the approval of the Board and the Veterans' Finance Committee of 1943 (the "Finance Committee"). The Finance Committee is comprised of the Governor, State Treasurer, State Controller, State Director of Finance and Secretary of the Department. Most Contracts of Purchase originated prior to January 1, 1999 currently bear interest at a rate of 6.95%. The Veterans Code currently requires that, generally, all Contracts of Purchase originated prior to January 1, 1999 (the "pre-1999 Contracts of Purchase") bear the same interest rate. In accordance with the current provisions of the Veterans Code, the interest rate for such pre-1999 Contracts of Purchase can be changed annually as deemed necessary. The effective date of a higher rate of interest on pre-1999 Contracts of Purchase may occur only once in any calendar year unless a finding is made by the Board and the Finance Committee that such additional action is necessary to protect the solvency of the 1943 Fund.

Legislation passed in 1998 (i) eliminated the uniform interest rate requirement for Contracts of Purchase originated on or after January 1, 1999; (ii) allows the Department to establish non-uniform fixed or variable interest rates for such Contracts of Purchase; and (iii) allows the Department to modify such interest rates, or the methodology and timing for determining or modifying interest rates, from time to time, subject to the approval of the Board and the Finance Committee. Contracts of Purchase entered into after January 1, 1999 have a variable rate allowing for an increase of up to one-half of one percent (0.5%) over the term of the loan. The Department has a flexible mechanism to provide for periodic adjustments of the interest rate on new Contracts of Purchase funded from Qualified Mortgage Bond Proceeds, QVMB Proceeds, and Unrestricted Moneys. As a result of such mechanism, interest rates for new Contracts of Purchase funded on and after July 5, 2006 are currently 6.50% for Contracts of Purchase financed using Qualified Mortgage Bond Proceeds and Unrestricted Moneys. Interest rates on Contracts of Purchase are expected to be established in the future based on various factors deemed appropriate by the Department, subject in all cases to the requirements of the resolution authorizing the issuance of Revenue Bonds (the “Revenue Bond Resolution”) for the filing of Cash Flow Statements and conformance with Program Operating Procedures. As noted herein, the Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Cash Flow Statement consists of the conclusion by an authorized representative of the Department that projected revenues will be sufficient to provide for timely payment of principal of and interest on the Revenue Bonds and expenses, under each scenario included in the quantitative analysis which accompanies the Cash Flow Statement. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Selected Principal Flows with respect to Contracts of Purchase funded by both Veterans G.O. Bonds and Revenue Bonds.”

*Legislative Protection of Veterans.* Federal law provides certain protections to military personnel on active duty, reservists or members of the National Guard ordered to report for military service under the Servicemembers’ Civil Relief Act of 2003, formerly known as The Soldiers’ and Sailors’ Civil Relief Act of 1940 (the “Relief Act”). Under the Relief Act, a servicemember may seek a stay (or a court may on its own motion grant a stay) of any court action or proceeding. The Relief Act provides that if a servicemember obtained a Contract of Purchase and is later recalled to active duty, then during the period of military service the interest rate on the Contract of Purchase cannot exceed 6% (unless the ability of the servicemember to pay interest in excess of 6% is not materially impaired by such military service). Accordingly, the effect of any application of the Relief Act in most cases would be a reduction in the applicable interest rate of less than one percent or no reduction at all.

In a voluntary survey conducted in 2003 approximately 375 holders of Contracts of Purchase indicated that they were members of the National Guard or the reserves subject to being called to active duty. To date, there has been no material impact on the 1943 Fund.

AB 306 also provides certain deferments to qualifying members of the United States Military Reserves of the California National Guard. See –“Recent Legislative Changes Affecting the Program” herein.

## **Loan Insurance**

*General.* Generally, for all new Contracts of Purchase with LTVs in excess of 80%, the Department requires veterans to obtain one of two loan insurance options, USDVA Guarantees or private primary mortgage insurance from Radian. The Department obtained primary mortgage insurance for Contracts of Purchase with LTVs in excess of 80% which were in place prior to implementation of the foregoing requirement. Since 2002 the Department has obtained, and continues to obtain, USDVA guarantees on (i) all Contracts of Purchase with LTVs of 97% or greater and (ii) Contracts of Purchase with LTVs in excess of 80% where the veteran qualifies for a USDVA guarantee at no charge due to a service related disability. The Department provides Radian primary mortgage insurance for those Contracts of Purchase not described in the preceding sentence which have LTVs in excess of 80%. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase – Current Loan-to-Value Ratio of Contracts of Purchase.”

*Funding of Loan Insurance.* In addition to the initial payment and the LOF, where no mortgage broker is involved, the Department collects a funding fee of 1.25% to 3.3% of the Contract of Purchase amount, based on the LTV for each Contract of Purchase which exceeds an LTV of 80%. For USDVA guaranteed loans, the funding fee may be added to the purchase price. For Radian guaranteed loans, the maximum loan amount is 97%, therefore the funding fee cannot be added to the loan unless the down payment is increased so that the total loan amount, including the funding fee, does not exceed 97%. Veterans obtaining loans described immediately above who are ineligible for a full USDVA guaranty and therefore are obligated to make an initial 3% payment must advance a funding fee of up to 2% of the base loan amount to the Department at close of escrow, and the funding fee may not be added to the base loan amount. With respect to eligible Contracts of Purchase, this fee is paid to the USDVA for the cost of the loan guaranty. If the veteran or the property is not eligible for a USDVA loan guaranty, the funding fee is retained by the Department, and a portion of such funding fees is used by the Department to pay costs related to the Radian primary mortgage insurance. Any change to the foregoing insurance and guaranty expectations could require an amendment to the Department’s Program Operating Procedures and delivery of a new Cash Flow Statement. Significant principal amounts of Contracts of Purchase are not covered by loan insurance. See EXHIBIT 2 to this APPENDIX B - “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA - Contracts of Purchase - Existing Contracts of Purchase - Current Loan-to-Value Ratio of Contracts of Purchase.”

*Primary Mortgage Insurance.* The Department purchased from Radian a policy of primary mortgage insurance for a pool of certain prior Contracts of Purchase with LTVs above 80%. The insurance financial strength of Radian is rated “AA” by S&P, “Aa3” by Moody’s and “AA” by Fitch. Such ratings reflect only the view of the respective rating agencies and an explanation of the significance of such ratings may be obtained from the respective rating agencies. There is no assurance that the ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by such ratings agencies if, in their judgment, circumstances so warrant. The Radian policy provides coverage on such pool back to February 1, 1998.

As described above, the Department has purchased an additional policy of primary mortgage insurance from Radian which provides similar coverage as provided in the original policy, except that the Department now includes certain existing and all new Contracts of Purchase with 97% to 100% LTV that are not qualified for USDVA guarantees (except home improvement loans, which continue to be covered by the Department). See “ – Loan Insurance – General” herein. Under this second policy, Radian has committed to insure Contracts of Purchase originated by the Department after January 1, 2000 until the aggregate principal amount of Contracts of Purchase insured under the second policy reaches \$1.6 billion. Each of the Radian policies provides coverage for aggregate losses incurred on Contracts of Purchase following property disposition, above an aggregate 2% deductible based upon a percentage of the originally insured balances of the Contracts of Purchase of the applicable pool. Under both Radian policies, once the applicable aggregate deductible has been reached, insurance claims may be made based upon the individual LTV of the particular defaulted Contract of Purchase, as set forth below. For these purposes, LTV is calculated using the original appraised value of the property.

**Radian Mortgage Insurance Coverage Ratios Subject to a  
Deductible of 2% of the Originally Insured Balances of the  
Contracts of Purchase in the Applicable Insured Pool**

<u>LTV Category</u>	<u>% of Coverage</u>
97.01% to 100.00%	35%
95.01% to 97.00%	35%
90.01% to 95.00%	30%
85.01% to 90.00%	25%
80.01% to 85.00%	17%

For information regarding the principal amount of Contracts of Purchase covered by the Radian policies, see EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase - Current Loan-to-Value Ratio of Contracts of Purchase.”

*USDVA Guaranty Program.* The Department was approved by the USDVA as a “supervised lender with automatic processing authority” as of March 10, 1998. This approval allows the Department to underwrite and approve USDVA guaranteed loans without obtaining prior USDVA approval. On July 27, 1998, the Department received USDVA approval under the Lender Appraisal Processing Program (“LAPP”) to review appraisals and issue notice to the buyers of the market value of the property for USDVA guaranteed loans without prior USDVA review. The Department seeks USDVA loan guarantees for Contracts of Purchase with a LTV of 97% or higher and on loans with LTVs of 80% or greater where the veteran qualifies for a USDVA guarantee at no charge due to a service-related disability. Contracts of Purchase may not be eligible for a USDVA guarantee where (i) the veteran has previously used his/her USDVA guaranty eligibility and does not qualify for reinstatement, (ii) the Contract of Purchase is for the purchase of a new home not inspected by USDVA during construction or (iii) the purchase price exceeds USDVA limits. Also, a very small number of veterans have service that meets Veterans Code eligibility requirements but not USDVA eligibility requirements.



The Servicemen's Readjustment Act of 1944, as amended, permits a veteran (or in certain instances the veteran's spouse) to obtain a mortgage loan guaranty from USDVA covering mortgage financing of the purchase or construction of a one-to-four family dwelling unit at interest rates permitted by USDVA. The USDVA program has no preset mortgage loan limits and permits the guaranty of mortgage loans of up to 30 years and 32 days' duration unless the USDVA, in its sole discretion, approves an extension. Under the USDVA program, the maximum USDVA guaranty on a loan is an amount equal to 25% of the Freddie Mac conforming loan limit for a single family residence. The Freddie Mac conforming loan limit for a single family residence for 2006 is \$417,000. The liability on the guaranty is reduced or increased *pro rata* with any reduction or increase in the amount of indebtedness, but in no event will the amount payable on the guaranty exceed the amount of the original guaranty. Notwithstanding the dollar and percentage limitations of the guaranty, a mortgage holder will ordinarily suffer a monetary loss only where the difference between the unsatisfied indebtedness and the proceeds of a foreclosure sale of a mortgaged property is greater than the original guaranty, as adjusted. Periods without interest payments prior to foreclosure increase the potential for losses. In the event of a default in the payment of a USDVA guaranteed loan, but prior to a suit or foreclosure, USDVA may, at its option, pay to a mortgage holder the unpaid balance of the obligation plus accrued interest and receive an assignment of the loan and security. For information regarding the amount of Contracts of Purchase guaranteed by the USDVA, see EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase - Current Loan-to-Value Ratio of Contracts of Purchase."

### **Property and Life and Disability Insurance**

The Veterans Code and/or long-standing Department policy have called for the veteran contract-holder to maintain certain insurance with respect to the property covered by a Contract of Purchase. Insurance must be in the amount and under the conditions specified by the Department, and is either provided by the Department or by insurance companies selected by the Department. Any change to the insurance requirements could require amending the Department's Program Operating Procedures.

*Fire and Hazard Coverage.* The Department self-insures for fire and hazard losses, using the 1943 Fund to make payments to veterans, up to a Department deductible. The Master Policy described below (the "Master Policy") provides \$50,000,000 coverage in excess of the Department deductible, except that the Master Policy does not cover mobile homes, condominiums or planned unit development properties covered by blanket insurance policies provided by homeowners' associations. The Department contracted with Marsh Risk and Insurance Services to conduct a Conflagration Exposure Analysis in fiscal year 2005. The analysis concluded that the probable maximum exposure risk to the properties insured under the Program from a major event, or conflagration, would not exceed \$20,000,000. The Master Policy is provided by commercial insurers (the "Provider"). The lead insurer for the Provider is Allianz Global Risks US Insurance Company.

Under each Contract of Purchase, the veteran is required to pay the sum charged to his or her account to cover costs of providing the insurance coverage with respect to his or her property including the insurance premium due under the Master Policy. Each veteran with a Contract of Purchase pays an annual insurance premium equal to \$0.22 per \$100 of

insured value that is prorated and included in the veteran's monthly installment. From the amount charged to each veteran, the Department retains a portion to provide the sums necessary to pay all losses up to the Department deductible, which is \$2,500,000 per occurrence or \$13,000,000 per policy year. If the total losses from a single occurrence exceed \$2,500,000 or if the aggregate of all fire and hazard insurance losses for a policy year exceed \$13,000,000, liability for the excess will be covered under the Master Policy. The coverage under the Master Policy extends to October 31, 2007. The Master Policy is an all-physical loss form.

Fire and hazard insurance coverage for participants in the Program is adjusted annually to reflect increased building costs, and is maintained on a guaranteed replacement cost basis for homes and on an actual cash value basis for outbuildings. A \$250 deductible payable by the veteran applies to each loss and claims must be submitted within 12 months of loss. Claims adjustments and payments are made on behalf of the Department and the provider of the Master Policy by Sams and Associates, Inc.

*Disaster Indemnity Plan.* The Department provides certain disaster indemnity and catastrophe real property insurance ("Disaster Indemnity Plan"). Neither such insurance nor the indemnity fund described below are payable from or a part of the 1943 Fund. The Disaster Indemnity Plan indemnifies participants against the cost of repairing damage caused by flood or earthquake in excess of a deductible. The deductible for flood losses is \$500 and the deductible for earthquake losses is the greater of \$500 or 5% of the amount of loss. The catastrophe insurance has been obtained from a consortium of eight insurance companies for a total of \$50,000,000 of coverage with a \$4,000,000 deductible per occurrence and in the aggregate annually. Once such deductible has been exceeded, subsequent occurrences are subject to a \$100,000 per occurrence deductible. Of the \$50,000,000 coverage the Department is self-insured for 25% of \$10,000,000 (\$2,500,000) of losses in excess of \$20,000,000. The remaining 75% of such losses are covered by four of the insurance companies comprising the consortium described above. The 2006 one-year premium for this coverage was \$5,205,000.

Each veteran in the Program participates in the Disaster Indemnity Plan and pays his or her *pro rata* share of the annual premium. Such payments are deposited in an indemnity fund created in the Treasury of the State to be utilized to pay the deductible discussed above. Each veteran pays an initial assessment and annual premium of \$.80 per \$1,000 of insured value, and any assessments as may be required to sustain the indemnity fund. The value of the indemnity fund as of June 30, 2006 was approximately \$8,626,707.

Effective December 1, 1997, the Department began purchasing individual flood policies through the Federal Emergency Management Agency ("FEMA") covering all properties financed by Contracts of Purchase that are located in designated flood Zone A and Zone V. Zone A is the flood insurance rate zone that corresponds to the one percent (1%) annual chance floodplains determined in FEMA's Flood Insurance Study as part of the National Flood Insurance Program. Zone V is the flood insurance rate zone that corresponds to areas within the one percent (1%) annual chance coastal floodplains that have additional hazards associated with storm waves. Coverage under this policy is renewable annually.

*Life and Disability Coverage.* In the past, the Department self-insured life and disability coverage for veterans with Contracts of Purchase from the 1943 Fund. Following a period of significant and recurring losses incurred by the 1943 Fund, in 1996 the Department replaced most of its life and disability insurance program with an interim life and disability insurance plan (the “Life and Disability Plan”) provided by Pacific Life and Annuity Company (“Pacific Life”). In 1998, the interim plan was replaced with a long-term life insurance and disability plan, also provided by Pacific Life. In 2003, the Pacific Life plan was replaced by a three-to-five-year life insurance and disability plan, provided by the Standard Insurance Company. All holders of Contracts of Purchase who had life and disability coverage (exclusive of those receiving self insured benefits described above) under the Pacific Life plan were transferred automatically to the Standard Insurance Company plan. The Department continues to self-insure those veterans who were already receiving disability benefits at the time the Life and Disability Plan was implemented, with benefits equal to the amount of the monthly Contract of Purchase payment at the time of their disability. Those benefits will continue under the provisions of the self-insured plan until the beneficiary returns to active employment or dies, or his or her loan balance is paid off. Loss reserves for these obligations are actuarially based. The Department holds funds in the 1943 Fund to pay all benefits under the self-insured plan. See “THE 1943 FUND – SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT’S DISCUSSION” in this APPENDIX B.

Major elements of the Life and Disability Plan include, for life insurance a five-year principal and interest benefit under the mandatory life coverage. Disability coverage, which is optional, has a 90-day waiting period with a maximum 24-month benefit, unless the injury was the cause of an accident, which would allow for a maximum 60-month benefit. These benefits continue to age 62 for disability and age 70 for life benefit.

### **External Review of the Program**

The Program and the Department have been the subject of external reviews as summarized below.

#### *Bureau of State Audits*

On May 25, 2000, the Bureau of State Audits (“BSA”) released an audit report (the “2000 BSA Report”) concluding that the Program will substantially lose its ability to offer low-cost home loans to veterans beyond the next decade due to the restrictive eligibility requirements attributed to certain Program funding and the limited availability of other funding sources. The BSA further concluded that the Department was eroding Program funds due to insufficient budget controls, inefficient and inconsistent loan operations and by charges to the loan Program for unrelated administrative positions and costs. Finally, the BSA concluded, based in part upon its conclusion that the Department’s testing of its integrated information system was incomplete, that the Department will need to spend more time and money to ensure that its integrated information system provides necessary, reliable program and financial information. The Department disagreed with certain conclusions of the BSA and expressed the belief that it had already addressed certain report findings.

Copies of the 2000 BSA Report, including the Department’s responses thereto, are available from the Department upon request.

In June 2003, the BSA released its report pertaining to the Board and to the Department's responses to recommendations in prior audits (the "2003 BSA Report"). The 2003 BSA Report concluded among other things, that (i) the Board had not established itself as an effective policy-maker for the Department; (ii) the Board lacked independent counsel to minimize the legal risks of its policy-making and appeals actions; (iii) the Board's appeal process needed improvement to ensure that veterans' appeals are handled consistently and appropriately; (iv) the Board's effectiveness was hindered by its reduced membership and lack of training on its responsibilities; and (v) although the Department had implemented recommendations that were reviewed from previous BSA audits, it had not given sufficient attention to the projected decrease in the number of veterans who will be eligible for loans backed by qualified veterans' mortgage bonds which could affect the long-term viability of the Program.

The Board and the Department responded in writing to the 2003 BSA Report. With respect to point (i) in the prior paragraph, the Board stated that it will develop action plans based on recommendations provided in the 2003 BSA Report and will seek outside legal counsel to assist in formulating policies for the Board. The Board adopted a policy in December, 2004 which permits the hiring of a retired attorney to provide assistance to the Board in the development of policies and other matters. The Board is currently in the process of hiring such a Special Counsel. With respect to points (ii) and (iii) in the prior paragraph, the Board stated in its response that it will create a manual and include procedures for conducting all levels of appeals and it will establish a policy for having independent counsel and will provide funding accordingly. The Board has adopted an appeals procedure but has not completed development of a pamphlet for appellants to explain the appeals process. As mentioned above, the Board is in the process of hiring a Special Counsel. With respect to point (iv) in the prior paragraph, the Board stated that it will appoint a training coordinator and develop a formalized training plan for the Board. The Board adopted a formal orientation program for new Board members which includes ongoing training by a Department training coordinator, an overview of Board member duties and responsibilities and provision of copies of the Veterans Code and the Bagley-Keene Act. With respect to point (v) in the prior paragraph, the Department stated that it is addressing this issue through its efforts to effect passage of federal legislation and it is continuing to monitor funding pools to determine if and when an alternative funding source may be necessary. In particular, the Department explained that in order to provide a home loan benefit to the greatest number of qualifying veterans, the Department engaged in efforts to change federal tax laws governing loans backed by qualified veterans' mortgage bonds. In 2005, the Department, along with agencies offering similar programs in four other states, worked on a new bill to change federal tax laws governing loans backed by qualified veterans' mortgage bonds. Efforts by the Department to change a federal law to expand eligibility for loans backed by qualified veterans' mortgage bonds while maintaining current available bonding authority were not successful. The Department plans to continue to seek changes to expand eligibility for loans backed by qualified veterans' mortgage bonds in 2007. There can be no assurance that any such efforts will be successful.

## **THE 1943 FUND**

### **General**

The components of the 1943 Fund are (i) proceeds derived from the sale of Revenue Bonds; (ii) proceeds from the sale of Veterans G.O. Bonds; (iii) amounts receivable under all Contracts of Purchase and from sales of properties subject to cancelled Contracts of Purchase; (iv) temporary investments, cash and funds and (v) certain other miscellaneous assets. Proceeds of Veterans G.O. Bonds may not be applied to payment of principal of, and interest or any redemption premium on, the Revenue Bonds. The holders of Revenue Bonds are not entitled to compel the sale of Contracts of Purchase and the properties to which they relate, but are entitled to receive payment out of the Revenues derived from those Contracts of Purchase and properties, subject to the prior claims, if any, of the Veterans G.O. Bonds and of the State for reimbursement of debt service payments made on Veterans G.O. Bonds.

In addition to financing Contracts of Purchase and paying or reimbursing debt service on the Veterans G.O. Bonds and Revenue Bonds, as described below, moneys in the 1943 Fund are used to pay administrative costs of the Department, and to fund certain losses from and reserves for property insurance and life and disability insurance described in “THE PROGRAM – Property and Life and Disability Insurance.”

For financial information concerning the 1943 Fund, see EXHIBIT 1 to this APPENDIX B – “FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 2006 AND 2005 AND INDEPENDENT AUDITOR’S REPORT”.

The Veterans’ Revenue Debenture Act of 1970, as amended (the “Act”) and the Veterans Code provide that the undivided interest created by Resolution RB-1 in favor of the holders of Revenue Bonds in the assets of the 1943 Fund is secondary and subordinate to the interest of the people of the State and the holders of Veterans G.O. Bonds. The 2000 Bond Act provides that on the dates when funds in the General Fund are remitted to bond owners for the payment of debt service on Veterans G.O. Bonds issued under the 2000 Bond Act, moneys shall be returned to the General Fund from the 1943 Fund in an amount equal to such debt service payment (to the extent sufficient moneys are available in the 1943 Fund). Moneys in the 1943 Fund must be paid, on the debt service payment dates of Veterans G.O. Bonds (other than those issued under the 2000 Bond Act), to the General Fund in the amount of the principal of (whether at maturity or upon redemption or acceleration), and premium and interest on Veterans G.O. Bonds then due and payable (other than debt service payable from the proceeds of refunding bonds). Debt service on Veterans G.O. Bonds is payable from the General Fund, even if the amount transferred from the 1943 Fund to the General Fund is less than such debt service amount. The balance remaining unpaid to the General Fund from the 1943 Fund must be transferred to the General Fund out of the 1943 Fund as soon thereafter as it becomes available, together with interest thereon at the rate borne by the applicable Veterans G.O. Bonds, compounded semiannually. Until such amounts are repaid to the General Fund, no payments may be made on the Revenue Bonds other than from amounts then in the Bond Reserve Account and the Loan Loss Account. These rights with respect to the 1943 Fund do not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

As of September 30, 2006, there were outstanding \$1,279,590,000 aggregate principal amount of Veterans G.O. Bonds. Currently, \$485,585,000 of new issue Veterans G.O. Bonds are authorized but not issued (not including the Offered Veterans G.O. Bonds). As of September 30, 2006, there were \$543,360,000 aggregate principal amount of Revenue Bonds outstanding, not including the Offered Revenue Bonds. Under the Act, Revenue Bonds in an aggregate principal amount not to exceed \$1,500,000,000, at any given time, may be outstanding. The Legislature may increase the amount of Revenue Bonds issueable under the Act or may decrease such amount to an amount not less than the amount of Revenue Bonds then outstanding. Additional information about outstanding Veterans G.O. Bonds and Revenue Bonds is in Exhibit 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds.”

For additional information regarding the existing interest rates of, and setting interest rates on, Contracts of Purchase, see “THE PROGRAM – Contracts of Purchase” herein and EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase.”

### **Selected Financial Data of the 1943 Fund and Department’s Discussion**

#### *Selected Financial Data of the 1943 Fund*

The following table (the “Selected Financial Data”) contains selected financial data of the 1943 Fund for fiscal years ended June 30, 2006 and 2005 which has been derived from the financial statements of the 1943 Fund audited by Deloitte & Touche LLP, independent auditors, whose report thereon appears in EXHIBIT 1 to this APPENDIX B, and the Department’s accounting records. The Selected Financial Data also contains the comparable financial data of the 1943 Fund for fiscal years ended June 30, 2004, 2003 and 2002, which has been derived from the audited financial statements of the 1943 Fund that are not included herein. **This selected financial data should be read in conjunction with the financial statements and notes thereto of the 1943 Fund contained in said EXHIBIT 1 and the Department’s Discussion of Financial Data contained herein.**

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# SELECTED FINANCIAL DATA OF THE 1943 FUND

(Dollars in Thousands)

For Fiscal Years Ending on

	<u>June 30, 2006</u>	<u>June 30, 2005</u>	<u>June 30, 2004</u>	<u>June 30, 2003</u>	<u>June 30, 2002</u>
<b>ASSETS AND LIABILITIES RELATED TO LENDING AND FINANCING ACTIVITIES:</b>					
<b>CASH AND INVESTMENTS</b>					
Cash and amounts on Deposit in SMIF	\$ 446,374	\$ 538,046	\$ 589,654	\$ 728,511	\$ 515,052
Guaranteed Investment Contracts	120,356	116,253	154,890	265,595	363,685
Treasury Securities	0	0	0	0	0
	<u>\$ 566,730</u>	<u>\$ 654,299</u>	<u>\$ 744,544</u>	<u>\$ 994,106</u>	<u>\$ 878,737</u>
<b>DUE FROM VETERANS DEBENTURE REVENUE FUND</b>	\$ 37,765	\$ 37,510	\$ 37,532	\$ 37,411	\$ 37,346
<b>OTHER CURRENT ASSETS</b>	12,586	11,045	10,504	14,517	20,620
<b>NET OTHER NON-CURRENT ASSETS</b>	4,385	3,301	10,160	4,751	6,120
<b>CONTRACTS OF PURCHASE</b>					
Performing Contracts	1,511,853	1,485,528	1,536,490	1,766,419	2,356,055
Non Performing Contracts	1,198	2,350	2,987	6,248	9,543
Total	<u>1,513,051</u>	<u>1,487,878</u>	<u>1,539,477</u>	<u>1,772,667</u>	<u>2,365,598</u>
Allowance For Contract Losses	\$ (8,050)	\$ (8,300)	\$ (8,540)	\$ (10,040)	\$ (14,135)
Reduction of REO to Fair Value	(151)	(351)	(527)	(1,020)	(2,300)
Total	<u>\$ (8,201)</u>	<u>\$ (8,651)</u>	<u>\$ (9,067)</u>	<u>\$ (11,060)</u>	<u>\$ (16,435)</u>
<b>BONDS PAYABLE</b>					
General Obligation Bonds and Notes	\$ (1,335,640)	\$ (1,356,315)	\$ (1,433,190)	\$ (1,979,685)	\$ (2,346,930)
Revenue Bonds	(543,360)	(569,075)	(617,445)	(521,475)	(548,210)
Total	<u>\$ (1,879,000)</u>	<u>\$ (1,925,390)</u>	<u>\$ (2,050,635)</u>	<u>\$ (2,501,160)</u>	<u>\$ (2,895,140)</u>
<b>OTHER CURRENT LIABILITIES</b>	\$ (16,329)	\$ (19,619)	\$ (22,312)	\$ (19,261)	\$ (90,047)
<b>Net Lending &amp; Financing Activities Assets</b>	<u><b>\$ 230,987</b></u>	<u><b>\$ 240,373</b></u>	<u><b>\$ 260,203</b></u>	<u><b>\$ 291,971</b></u>	<u><b>\$ 306,799</b></u>
<b>ASSETS AND LIABILITIES RELATED TO INSURANCE ACTIVITIES:</b>					
<b>LIFE AND DISABILITY COVERAGE</b>					
Cash Reserve for Life and Disability	\$ 5,324	\$ 5,000	\$ 7,388	\$ 6,387	\$ 9,875
Insurance Loss Reserves	(11,408)	(15,000)	(17,600)	(19,900)	(22,653)
Total	<u>\$ (6,084)</u>	<u>\$ (10,000)</u>	<u>\$ (10,212)</u>	<u>\$ (13,513)</u>	<u>\$ (12,778)</u>
<b>FIRE AND HAZARD COVERAGE</b>					
Deposits with Insurance Administrators	\$ 1,000	\$ 1,050	\$ 1,850	\$ 1,850	\$ 1,850
Accrued Liabilities	(2,600)	(1,591)	(2,512)	(2,035)	(1,950)
Total	<u>\$ (1,600)</u>	<u>\$ (541)</u>	<u>\$ (662)</u>	<u>\$ (185)</u>	<u>\$ (100)</u>
<b>Net Insurance Activities Liabilities</b>	<u><b>\$ (7,684)</b></u>	<u><b>\$ (10,541)</b></u>	<u><b>\$ (10,874)</b></u>	<u><b>\$ (13,698)</b></u>	<u><b>\$ (12,878)</b></u>
<b>RETAINED EARNINGS</b>	<u><b>\$ 223,303</b></u>	<u><b>\$ 229,832</b></u>	<u><b>\$ 249,329</b></u>	<u><b>\$ 278,273</b></u>	<u><b>\$ 293,921</b></u>
<b>SUMMARY INFORMATION</b>					
Total Assets	\$ 2,133,000	\$ 2,191,000	\$ 2,342,000	\$ 2,821,000	\$ 3,304,000
Total Liabilities	\$ 1,910,000	\$ 1,961,000	\$ 2,093,000	\$ 2,542,000	\$ 3,010,000
Total Number of Contracts of Purchase	14,996	16,470	18,699	22,397	28,605

# SELECTED FINANCIAL DATA OF THE 1943 FUND

(Dollars in Thousands)

For Fiscal Year Ending on

	<u>June 30, 2006</u>	<u>June 30, 2005</u>	<u>June 30, 2004</u>	<u>June 30, 2003</u>	<u>June 30, 2002</u>
<b>NET INCOME FROM LENDING AND FINANCING ACTIVITIES:</b>					
<b>INTEREST INCOME</b>					
Interest on Contracts	\$ 84,527	\$ 90,794	\$ 100,676	\$ 140,036	\$ 166,086
Interest on Investments	27,900	19,220	23,613	34,142	38,107
Transfers of Interest From Veterans Debenture Revenue Fund	2,021	2,034	2,009	2,029	2,403
Total	<u>\$ 114,448</u>	<u>112,048</u>	<u>\$ 126,298</u>	<u>\$ 176,207</u>	<u>\$ 206,596</u>
<b>BOND INTEREST EXPENSE</b>	<u>\$ (110,027)</u>	<u>\$ (111,811)</u>	<u>\$ (136,882)</u>	<u>\$ (169,143)</u>	<u>\$ (184,654)</u>
<b>Net Interest Income</b>	<u>\$ 4,421</u>	<u>\$ 237</u>	<u>\$ (10,584)</u>	<u>\$ 7,064</u>	<u>\$ 21,942</u>
<b>GASB 31 ADJUSTMENT</b>	\$ 0	\$ 0	\$ 215	\$ 532	\$ 554
<b>GAIN ON SALE OF SECURITIES</b>	0	0	0	0	0
<b>RESTRUCTURING EXPENSES</b>	<u>(1,407)</u>	<u>(2,219)</u>	<u>(8,164)</u>	<u>(5,826)</u>	<u>(4,780)</u>
Total	<u>\$ (1,407)</u>	<u>\$ (2,219)</u>	<u>\$ (7,949)</u>	<u>\$ (5,294)</u>	<u>\$ (4,226)</u>
<b>CONTRACTS OF PURCHASE</b>					
PMI	\$ (988)	\$ (1,531)	\$ (2,991)	\$ (1,845)	\$ (2,565)
Net gain (loss) on Sale of REO'S	204	673	1,173	2,092	1,730
(Increase) Decrease in Allowance for Contract Losses	450	416	1,993	5,375	2,872
Total	<u>\$ (334)</u>	<u>\$ (442)</u>	<u>\$ 175</u>	<u>\$ 5,622</u>	<u>\$ 2,037</u>
<b>Net Lending/Financing Activities Income (Expense)</b>	<u>\$ 2,680</u>	<u>\$ (2,424)</u>	<u>\$ (18,358)</u>	<u>\$ 7,392</u>	<u>\$ 19,753</u>
<b>NET INCOME FROM ADMINISTRATIVE ACTIVITIES</b>					
Operating Revenues	\$ 5,812	\$ 5,582	\$ 7,967	\$ 5,813	\$ 4,417
Operating Expenses	(20,337)	(21,983)	(21,918)	(25,396)	(20,353)
<b>Net Administrative Activities Expense</b>	<u>\$ (14,525)</u>	<u>\$ (16,401)</u>	<u>\$ (13,951)</u>	<u>\$ (19,583)</u>	<u>\$ (15,936)</u>
<b>NET INCOME FROM INSURANCE ACTIVITIES</b>					
Life and Disability Coverage	\$ 695	\$ (881)	\$ 4,194	\$ (1,568)	\$ 896
Fire and Hazard Coverage	2,321	209	(829)	(1,889)	1,162
Transfer from Disaster Indemnity	2,300	0	0	0	0
<b>Net Insurance Activities Income (Expense)</b>	<u>\$ 5,316</u>	<u>\$ (672)</u>	<u>\$ 3,365</u>	<u>\$ (3,457)</u>	<u>\$ 2,058</u>
<b>TOTAL EXCESS (DEFICIENCY) OF REVENUES AND TRANSFERS OVER EXPENSES</b>	<u>\$ (6,529)</u>	<u>\$ (19,497)</u>	<u>\$ (28,944)</u>	<u>\$ (15,648)</u>	<u>\$ 5,875</u>
<b>RETAINED EARNINGS</b>	<u>\$ 223,303</u>	<u>\$ 229,832</u>	<u>\$ 249,329</u>	<u>\$ 278,273</u>	<u>\$ 293,921</u>



### *Department's Discussion of Financial Data*

Included as part of the financial statements contained in APPENDIX A is the section entitled "Management's Discussion and Analysis of Financial Position and Results of Operations" which presents management's discussion in relation to the financial statements of the 1943 Fund for the fiscal year ended June 30, 2006, the fiscal year ended June 30, 2005, and the changes from prior periods (the "Management Discussion and Analysis"). The Selected Financial Data is presented to provide a summary of the financial position and operations over a longer period of time, and a presentation of the significant changes that have occurred. Certain limited aspects of the Selected Financial Data are discussed below. This discussion should be read in conjunction with the Management Discussion and Analysis contained in APPENDIX A and with APPENDIX C entitled "Certain Department Financial Information and Operating Data."

The Selected Financial Data reflects the changing conditions in the capital market environment in which the 1943 Fund operates during two discrete periods: (i) the period including the three fiscal years ended June 30, 2004 (the "Falling Rate Period") - during which interest rates on conventional mortgages and short term money market instruments gradually shifted downward to historically low levels, and (ii) the period including the two fiscal years ended June 30, 2006 (the "Rising Rate Period") - during which interest rates on conventional mortgages and short term money market instruments generally shifted upward towards more traditional levels. During the Falling Rate Period, the financial performance of the 1943 Fund deteriorated year over year, moving from an excess of revenues and transfers over expenses of \$5,875,000 in the fiscal year ended June 30, 2002 to a deficiency of revenues and transfers over expenses of \$28,944,000 in the fiscal year ended June 30, 2004. With the onset of the Rising Rate Period, the financial performance of the 1943 Fund started to improve year over year, with a reduced deficiency of revenues and transfers over expenses of \$6,529,000 in the fiscal year ended June 30, 2006.

#### *Falling Rate Period*

During the Falling Rate Period, in part as a consequence of prepayments of Contracts of Purchase refinanced by lower rate conventional mortgages, and in part as a consequence of new originations of Contracts of Purchase lost to highly competitive conventional mortgages (including adjustable rate mortgages), Contracts of Purchase held under the 1943 Fund declined by \$826,121,000 over just two fiscal years, from \$2,365,598,000 as of June 30, 2002 to \$1,539,477,000 as of June 30, 2004. The impact of this shrinkage in the assets of the 1943 Fund was compounded by adverse turnover of the portfolio, with the more rapid prepayment of higher interest rate Contracts of Purchase, and the origination of new Contracts of Purchase at progressively lower interest rates. In the fiscal year ended June 30, 2002, the average interest rate on outstanding Contracts of Purchase was approximately 6.8%; in the fiscal year ended June 30, 2004, the average interest rate had fallen to approximately 6.3%.

Over the same two fiscal years, as a result of the use of significant amounts of prepayments and unexpended proceeds to redeem bonds, the balance of Veterans G.O. Bonds and Revenue Bonds payable from the 1943 Fund declined by \$844,505,000, from \$2,895,140,000 as of June 30, 2002, to \$2,050,635,000 as of June 30, 2004. To a limited extent, the adverse turnover to the asset portfolio was offset by the Department's priority selection (subject to the requirements of the Resolution) of the higher interest rate Veterans G.O. Bonds for Special Redemption. In the fiscal year ended June 30, 2002, the average interest rate on

outstanding Veterans G.O. Bonds and Revenue Bonds was approximately 6.15%; in the fiscal year ended June 30, 2004, the average interest rate had fallen to approximately 6.00%.

The Department's ability to reduce the overall interest cost of Veterans G.O. Bonds and Revenue Bonds was limited by its inability to redeem any of the outstanding Veterans G.O. Bonds issued prior to 1986 (the "Non-callable Bonds"). The Non-Callable Bonds, of which \$592,055,000 and \$459,970,000 were outstanding as of June 30, 2002 and June 30, 2004, respectively, mature in installments through October 1, 2010, and bear an average interest rate of over 9%. Notwithstanding this short term fixed repayment schedule, the high level of early redemptions of other Veterans G.O. Bonds resulted in the increase in the Non-Callable Bonds as percentage of the outstanding Veterans G.O. Bonds from approximately 25% as of June 30, 2002, to approximately 32% as of June 30, 2004. Exclusive of the Non-Callable Bonds, the average interest rate on outstanding Veterans G.O. Bonds and Revenue Bonds was approximately 5.35% in the fiscal year ended June 30, 2002, and had fallen to approximately 5.14% in the fiscal year ended June 30, 2004.

While the cash produced by the decline in the balance of Contracts of Purchase over the two year period was offset by a corresponding application of cash to the reduction of the amount of Veterans G.O. Bonds and Revenue Bonds payable, the Department faced challenges from declining yields on its invested funds. Repayments of Contracts of Purchase were invested in the 1943 Fund temporarily pending use for the payment or redemption of bonds (with QVMB Proceeds and Qualified Mortgage Bond Proceeds) or for the financing of new Contracts of Purchase (with Unrestricted Moneys). In the case of the Unrestricted Moneys, repayments significantly exceeded new originations over the two-year period ending June 30, 2004, resulting in an accumulation of cash, much of which (generally amounts not related to bonds for federal tax purposes) was deposited in the Surplus Money Investment Fund ("SMIF"). As of June 30, 2003, the total amount on deposit in the SMIF was \$728,511,000, an increase of \$213,495,000 over the amount on deposit as June 30, 2002 (which itself represented a significant increase over the prior year). As the deposits grew, the impact became increasingly negative as short-term interest rates generally declined, and as the SMIF yields followed. In the fiscal year ended June 30, 2002, the average yield paid to depositors in SMIF was approximately 3.4%; in the fiscal year ended June 30, 2004, this average yield had fallen to approximately 1.5%.

The contraction of the balance sheet, the shift in the mix of assets, and the decline (or inversion) of the spreads between asset yields and bond rates all contributed to a significant and rapid deterioration of the financial performance of the 1943 Fund over the Falling Rate Period. These factors are directly reflected in net interest, which reversed from a net income of \$21,942,000 for the year ending June 30, 2002 to a net loss of \$10,584,000 for the year ending June 30, 2004. In addition, as a result of the increase in early redemption of Veterans G.O. Bonds and Revenue Bonds, non-cash amortization expense related to the previously expended costs of issuing and restructuring bonds increased steadily from \$4,780,000 for the year ending June 30, 2002, to \$8,164,000 for the year ending June 30, 2004. Total excess (deficiency) of revenues and transfers over expenses deteriorated correspondingly.

Notwithstanding the negative impact of these factors on retained earnings, which declined from \$293,921,000 as of June 30, 2002 to \$249,329,000 as of June 30, 2004, the amount of retained earnings of the 1943 Fund continued to improve in relationship to outstanding assets and liabilities. The overall asset-to-liability ratio for the 1943 Fund increased steadily from 109.8% as of June 30, 2002, to 111.9 % as of June 30, 2004.

### *Rising Rate Period*

During the Rising Rate Period, the financial performance of the 1943 Fund benefited from both the improvement in the market environment and the implementation by the Department of strategies to mitigate the impact of adverse market conditions. As a result of less competitive conditions in the conventional mortgage market, Contracts of Purchase held under the 1943 fund declined by only \$26,143,792 over the two fiscal years, ending at \$1,513,333,208 as of June 30, 2006. Even though interest rates on newly originated Contracts of Purchase increased by approximately 125 basis points from their low at the start of the 2004 fiscal year, turnover of the portfolio continued to have a negative effect, with the more rapid prepayment rates on higher interest rate rather than lower interest rate Contracts of Purchase. The average interest rate on outstanding Contracts of Purchase fell to approximately 5.8% in the fiscal year ended June 30, 2006.

During the Rising Rate Period, the balance of Veterans G.O. Bonds and Revenue Bonds payable from the 1943 Fund declined by \$171,635,000, to \$1,879,000,000 as of June 30, 2006, of which \$150,365,000 represented bonds redeemed on July 15, 2004 from amounts made available during prior periods. During the Rising Rate Period, the Department continued its policy of utilizing repayments of Contracts of Purchase attributable to QVMB Proceeds and Qualified Mortgage Bond Proceeds to pay debt service, but with the reduced level of prepayments, Excess Revenues were not sufficient to provide for any additional non-mandatory special redemption. Issuance of \$120,000,000 of new qualified veterans' mortgage bonds in April 2005 largely offset the maturities of prior bonds. During the Rising Rate Period, the Department also continued its policy of utilizing repayments of Contracts of Purchase attributable to Unrestricted Moneys for the financing of new Contracts of Purchase, leaving unchanged the balance of outstanding bonds attributable to this portion of the Program.

During the Rising Rate Period, scheduled maturities reduced the balance of the Non-callable Bonds by \$142,595,000, to \$317,375,000 as of June 30, 2006, which represented approximately 25% of the outstanding Veterans G.O. Bonds at the time. In December, 2003, the Department issued the 2003 Series A Revenue Bonds, in variable rate mode, to refund prior fixed rate bonds. In April 2005, the Department issued the 2005 Series A Revenue Bonds and a portion of the Series CA/CB Veterans G.O. Bonds to refund prior fixed rate bonds at reduced fixed interest rates. As a result, with interest rates generally increasing, the Department was able to reduce the average interest rate on outstanding Veterans G.O. Bonds and Revenue Bonds to approximately 5.7% for the fiscal year ended June 30, 2006. Exclusive of the Non-Callable Bonds, the average interest rate on outstanding Veterans G.O. Bonds and Revenue Bonds was approximately 5.0% for the fiscal year ended June 30, 2006.

With increased competitiveness resulting in more rapid originations of Contracts of Purchase from Unrestricted Funds, amounts on deposit in the SMIF also continued to decline during the Rising Rate Period, with \$446,374,000 on deposit as of June 30, 2006. The increase in SMIF yields over this period represented a significant contribution to the improvement in the financial performance of the 1943 Fund; in the fiscal year ended June 30, 2006, the average yield paid to depositors in SMIF rose to approximately 3.8%, with end of period rates nearing 5%.

The stabilization of the balance sheet and the improvement of the spreads between asset yields and bond rates have all contributed to a significant recovery in the financial performance of the 1943 Fund over last the two-year period. These factors are directly reflected in net interest, which returned to positive with a net income of \$4,421,000 for the year ending June 30, 2006. As a result of reduced levels of early redemption of Veterans G.O. Bonds and Revenue

Bonds, non-cash amortization expense related to the previously expended costs of issuing and restructuring bonds has also been reduced, permitting Net Lending/Financing Activities Income to return to positive as well. Total excess (deficiency) of revenues and transfers over expenses has improved correspondingly, but remains negative, with a deficiency of revenues and transfers over expenses of \$6,529,000 for the year ending June 30, 2006.

Notwithstanding the negative impact of these factors on retained earnings, which declined to \$223,303,000 as of June 30, 2006, the amount of retained earnings of the 1943 Fund was very stable in relationship to outstanding assets and liabilities, ending with an overall asset-to-liability ratio of 111.7 % as of June 30, 2006.

The ability of the Department to return to an excess of revenues over expenses in future periods will depend upon a variety of factors including, among others: (a) the level of interest rates available on short-term investments (including the rate paid on SMIF and on newly acquired investment contracts) relative to the level of interest rates on outstanding bonds; (b) the rate of origination and the rate of prepayment of Contracts of Purchase, which will directly affect the amount of bond proceeds, recycling funds and revenues held in such investments; (c) the interest rates established from time to time by the Department for newly originated Contracts of Purchase relative to the interest cost on bonds issued to finance such Contracts of Purchase; (d) the interest rates on outstanding Contracts of Purchase relative to the interest cost on outstanding bonds, which will directly depend on the Department's ability to use special and optional redemption provisions to minimize the overall cost of outstanding debt (limited, over the near term by the Non-callable Bonds); (e) the market prices that can be achieved upon the sale of repossessed properties relative to the then-outstanding contract balances; (f) the level of insurance premiums that the Department collects under its existing life and disability coverage plan and fire and hazard coverage plan relative to actual claims experience and costs (net of reinsurance); and (g) the level of administrative expenses relative to the rate of origination and outstanding balances of the Contracts of Purchase. The Department expects that there will be significant variations in results in future periods, including additional periods in which there will be a deficit of revenues over expenses.

### **Excess Revenues**

The Department has covenanted with the holders of its Revenue Bonds to apply Revenues received with respect to Contracts of Purchase, after payment or reimbursement of debt service on Veterans G.O. Bonds, in a specified order of priority. The availability and use of Revenues can provide moneys for special redemption of the Offered Veterans G.O. Bonds (see "THE OFFERED VETERANS G.O. BONDS – Redemption – Special Redemption from Excess Revenues). For this purpose, "Revenues" means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect to the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the revenue account established under the Revenue Bond Resolution, (iii) amounts transferred to the revenue account from the bond reserve account or the loan loss amount established under the Revenue Bond Resolution, and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, liquidation proceeds, and insurance proceeds, *except* to the extent not included as "Revenues" pursuant to the provisions of any resolution authorizing the issuance of a series of Revenue Bonds.

The Department has covenanted with the Revenue Bond holders to administer the 1943 Fund and the Program and perform its obligations to such holders in accordance in all material respects with the then-current Program Operating Procedures. The Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Department may amend the Program Operating Procedures. The Program Operating Procedures will affect the Excess Revenues that will become available to redeem the Offered Veterans G.O. Bonds.

The Department has covenanted with the Revenue Bond holders to apply Revenues in the following order, after paying, or reimbursing for payments of, debt service on Veterans G.O. Bonds, including the costs of liquidity and credit enhancement facilities related thereto, and setting aside moneys as required under the Federal Tax Code to preserve the tax-exempt status of certain Veterans G.O. Bonds and Revenue Bonds, (1) to pay debt service on Revenue Bonds, (2) to pay the costs associated with liquidity and credit enhancement facilities, if any, for Revenue Bonds, (3) to replenish certain reserve funds established for the Revenue Bonds, (4) if the Department elects, to pay Department expenses, (5) to set aside a monthly accrual of Veterans G.O. Bond debt service, (6) if the Department elects, to finance Contracts of Purchase, and (7) with respect to Excess Revenues and certain tax restricted moneys, to redeem Veterans G.O. Bonds, including the Offered Veterans G.O. Bonds, and Revenue Bonds. For such purposes:

(a) “Excess Revenues” means, as of any date of calculation, Revenues in excess of Accrued Debt Service;

(b) “Accrued Debt Service” means, as of any date of determination and, as the context requires, with respect to all Revenue Bonds and Veterans G.O. Bonds (including the Offered Veterans G.O. Bonds), the sum of:

(i) the aggregate amount of scheduled interest and principal (except to the extent otherwise to be redeemed pursuant to clause (ii) or (iii) below) to become due after such date but on or before the end of the current debt service year, *less* the product of (x) the number of whole months remaining in the current debt service year and (y) the Monthly Debt Service Requirement;

(ii) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the revenue account created under the Revenue Bond Resolution; and

(iii) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding debt service year, to the extent that such obligation arises on account of amounts on deposit in such revenue accounts; and

(c) “Monthly Debt Service Requirements” means, as of any date of determination, one-twelfth of the aggregate amount of scheduled interest and principal to become due during the debt service year in which such date falls, as computed on the first day of such debt service year.

### **Maintenance of Fund Parity**

The Revenue Bond Resolution requires the Department to calculate “Fund Parity” at least annually. “Fund Parity” means (a) an amount equal to the difference between (i) all assets in the 1943 Fund and in the accounts established under the Revenue Bond Resolution, and (ii) the principal amount of all Revenue Bonds and Veterans G.O. Bonds outstanding (plus accrued interest reduced by (b) defined allowances and reserves for loss coverage on Contracts of Purchase and life and disability coverage on persons obligated under Contracts of Purchase. If

any such calculation shall not reflect that Fund Parity at least equals the percentage required by the Revenue Bond Resolution, the Department may be required to expend Excess Revenues to redeem Revenue Bonds until its recalculations of Fund Parity meet the test required by the Revenue Bond Resolution. Currently the applicable required percentage of Fund Parity is 25%. Such applicable percentage has been subject to rating agency confirmation.

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**EXHIBIT 1**  
**FINANCIAL STATEMENTS OF THE 1943 FUND**  
**FOR FISCAL YEARS 2006 AND 2005**  
**AND INDEPENDENT AUDITORS' REPORT**  
**VETERANS FARM AND HOME BUILDING FUND OF 1943,**  
**DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

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***Veterans Farm and Home  
Building Fund of 1943,  
Department of Veterans  
Affairs, State of California***

*Financial Statements for the Years  
Ended June 30, 2006 and 2005, and  
Independent Auditors' Report*

# VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS

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## INDEPENDENT AUDITORS' REPORT

California Veterans Board  
State of California  
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943 (the "Fund"), which is administered by the Department of Veterans Affairs of the State of California (the "Department") as of June 30, 2006 and 2005, and the related statements of revenues, expenses and changes in fund equity and of cash flows for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Fund, and are not intended to present the financial position of the Department or the results of its operations and cash flows of its proprietary funds.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California as of June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis on pages 2 through 8 is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

*Deloitte + Touche LLP*

October 10, 2006

# VETERANS FARM AND HOME BUILDING FUND OF 1943

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

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### Introduction – The Department of Veterans Affairs

The Department of Veterans Affairs (the “Department”) began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature of the Veterans Farm and Home Purchase Act of 1921 (the “Cal-Vet Farm and Home Program” or the “Program”). In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 which modified the Program to meet new needs of California’s veterans. The 1943 Act established the 1943 Fund in the State Treasury and the Department established the Veterans Farm and Home Building Fund of 1943 (the “Fund”), which is the principal fund utilized for the Cal-Vet Farm and Home Loan Program. Financing is provided as installment loans, which are referred to as Contracts of Purchase.

The sales of the Fund’s Home Purchase Revenue Bonds and Veterans General Obligations Bonds combined with monies received from prepayments of Contracts of Purchase and other revenues under the Program not needed at any given time to meet the then current bond retirement schedules and operating costs have financed the purchase of farms and homes since the Program’s inception. Expenditures are primarily for debt service and administration of the Program.

### Fiscal Year 2006 Compared to Fiscal Year 2005

#### Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2006 and June 30, 2005 (dollars in thousands) and the percentage change.

	2006	2005	Change	% Change
<b>ASSETS</b>				
Cash and investments	\$ 573,053	\$ 660,349	\$ (87,296)	(13.2)%
Receivables under contracts of purchase—net	1,503,802	1,477,228	26,574	1.8 %
Other receivables and assets	<u>55,785</u>	<u>53,855</u>	<u>1,930</u>	3.6 %
TOTAL ASSETS	<u>\$ 2,132,640</u>	<u>\$ 2,191,432</u>	<u>\$ (58,792)</u>	(2.7)%
<b>LIABILITIES AND FUND EQUITY</b>				
Liabilities:				
Bonds payable	\$ 1,868,478	\$ 1,913,776	\$ (45,298)	(2.4)%
Other payables and liabilities	<u>40,859</u>	<u>47,824</u>	<u>(6,965)</u>	(14.6)%
Total liabilities	1,909,337	1,961,600	(52,263)	(2.7)%
Fund Equity	<u>223,303</u>	<u>229,832</u>	<u>(6,529)</u>	(2.8)%
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 2,132,640</u>	<u>\$ 2,191,432</u>	<u>\$ (58,792)</u>	(2.7)%

***Assets***

Total assets decreased \$58.8 million from \$2.19 billion at June 30, 2005 to \$2.13 billion at June 30, 2006. This decrease consisted primarily of the following items:

Total cash and investments decreased \$87.3 million from \$660.3 million at June 30, 2005 to \$573 million at June 30, 2006. The decrease is the direct result of an increase in the loan portfolio and the reduction of outstanding bonds, primarily through scheduled maturities and mandatory redemptions of bonds.

Net receivables under contracts of purchase increased \$26.6 million from \$1.48 billion at June 30, 2005 to \$1.50 billion at June 30, 2006. The change was due to rising interest rates in the housing market, which made the Program's loans more attractive to veterans, causing an increase in loan originations and reduced prepayments, while high property values in California resulted in larger individual loans.

All other receivables and assets increased by \$1.9 million from \$53.9 million at June 30, 2005 to \$55.8 million at June 30, 2006. This is due primarily to a \$1.8 million deposit to the Architecture Revolving Fund for the headquarters building heating and cooling project.

***Liabilities and Fund Equity***

Bonds payable and other payables and liabilities decreased \$52.3 million from \$1.96 billion at June 30, 2005 to \$1.91 billion at June 30, 2006. This net decrease is primarily the result of scheduled maturities and mandatory redemptions not replaced by commercial paper.

Fund equity decreased by \$6.5 million from \$229.8 million at June 30, 2005 to \$223.3 million at June 30, 2006, which represents an \$8.8 million excess of expenses over revenue for the fiscal year period, offset by a \$2.3 million transfer from the Disaster Indemnity Fund (Note 12).

The total asset to liability ratio for the Fund remained unchanged at 1.12 as of June 30, 2006 and June 30, 2005.

## Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2006 and June 30, 2005 (dollars in thousands) and the percentage change.

	2006	2005	Change	% Change
<b>PROGRAM OPERATIONS:</b>				
Interest revenues:				
Contracts of purchase	\$ 84,527	\$ 90,794	\$ (6,267)	(6.9)%
Investments and other	<u>29,921</u>	<u>21,254</u>	<u>8,667</u>	40.8 %
Total program operating revenues	114,448	112,048	2,400	2.1 %
Expenses:				
Interest expense	111,434	114,030	(2,596)	(2.3)%
Loan reserve change	<u>(450)</u>	<u>(416)</u>	<u>(34)</u>	8.2 %
Total program operating expenses	<u>110,984</u>	<u>113,614</u>	<u>(2,630)</u>	(2.3)%
Excess of program operations expenses over program operations revenues	<u>3,464</u>	<u>(1,566)</u>	<u>5,030</u>	(321.2)%
<b>PROGRAM ADMINISTRATION:</b>				
Total program administration revenues	8,133	5,791	2,342	40.4 %
Total program administration expenses	<u>20,630</u>	<u>24,395</u>	<u>(3,765)</u>	(15.4)%
Excess of program operations expenses over program operations revenues	<u>(12,497)</u>	<u>(18,604)</u>	<u>6,107</u>	(32.8)%
Gain on sale of repossessed property	<u>204</u>	<u>673</u>	<u>(469)</u>	(69.7)%
Excess of expenses over revenues	<u>\$ (8,829)</u>	<u>\$ (19,497)</u>	<u>\$ 10,668</u>	(54.7)%

### *Program Operations*

Interest revenue from contracts of purchase decreased by \$6.3 million from \$90.8 million for the year ended June 30, 2005 to \$84.5 million for the year ended June 30, 2006, primarily due to the replacement of higher rate contracts during the year with new contracts at lower rates.

Interest revenues on investments increased by \$8.6 million from \$21.3 million for the year ended June 30, 2005 to \$29.9 million for the year ended June 30, 2006. This increase is due to the SMIF quarterly interest rate increasing over the fiscal year from 2.85% at June 30, 2005 to 4.53% at June 30, 2006.

Interest expense decreased by \$2.6 million from \$114 million for the year ended June 30, 2005 to \$111.4 million for the year ended June 30, 2006. The decrease is due to a reduction in bonds outstanding, combined with the savings achieved by the refunding of outstanding bonds to lower interest rates near the end of the year ended June 30, 2005.

Program operation revenues for the fiscal year ended June 30, 2006 are in excess of program operations expenses by \$3.5 million compared to a deficiency of \$1.6 million for the year ended June 30, 2005. This program improvement is due to increased investment earnings and lower debt interest expense.

### ***Program Administration***

Program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance, other miscellaneous fees collected from program participants, rental income, and certain reimbursements of prior expenses, among others. Revenues increased by \$2.3 million from \$5.8 million for the year ended June 30, 2005 to \$8.1 million for the year ended June 30, 2006. The increase is primarily the result of an increase in fire and hazard insurance revenue due to a program-wide adjustment to property replacement values.

Total program administration expenses decreased by \$3.8 million from \$24.4 million for the year ended June 30, 2005 to \$20.6 million for the year ended June 30, 2006. The decrease is due to a reduction of payroll and other support expenditures as well as a reduction in the reserve requirement for the self-insured life and disability program.

Gain on Sale of Repossessed Properties decreased \$.5 million from the last fiscal year. This decrease is due to reduced sales of repossessed properties as the Department's holdings of these properties went from \$2.5 million as of June 30, 2005 to \$1.2 million as of June 30, 2006.

### **Economic Factors Facing Veterans Farm & Home Building Fund of 1943**

At June 30, 2006, the Program's loan portfolio balance was at approximately \$1.5 billion, an increase of \$26.6 million, or 1.8%, from \$1.48 billion at June 30, 2005. During the fiscal year, Cash and Investment balance decreased \$87.3 million, or 13.22%, from a balance of \$660.3 million to \$573 million. Much of the decrease in Cash and Investment balance was used to retire bonds prior to scheduled maturities.

Bonds payable decreased \$45.3 million, or 2.37%, from \$1.914 billion at June 30, 2005 to \$1.868 billion at June 30, 2006. Bond ratings for the Department's GO bonds are AA-, A1 and A+ by rating agencies Standard & Poor's, Moody's and Fitch, respectively. Bond ratings for the Department's Revenue bonds are AA-, Aa2 and AA- by Standard & Poor's, Moody's and Fitch, respectively.

## Fiscal Year 2005 Compared to Fiscal Year 2004

### Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2005 and June 30, 2004 (dollars in thousands) and the percentage change.

	2005	2004	Change	% Change
<b>ASSETS</b>				
Cash and investments	\$ 660,349	\$ 753,782	\$ (93,433)	(12.4)%
Receivables under contracts of purchase—net	1,477,228	1,527,950	(50,722)	(3.3)%
Other receivables and assets	<u>53,855</u>	<u>60,656</u>	<u>(6,801)</u>	(11.2)%
TOTAL ASSETS	<u>\$ 2,191,432</u>	<u>\$ 2,342,388</u>	<u>\$ (150,956)</u>	(6.4)%
<b>LIABILITIES AND FUND EQUITY</b>				
Liabilities:				
Bonds payable	\$ 1,913,776	\$ 2,039,554	\$ (125,778)	(6.2)%
Other payables and liabilities	<u>47,824</u>	<u>53,505</u>	<u>(5,681)</u>	(10.6)%
Total liabilities	1,961,600	2,093,059	(131,459)	(6.3)%
Fund Equity	<u>229,832</u>	<u>249,329</u>	<u>(19,497)</u>	(7.8)%
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 2,191,432</u>	<u>\$ 2,342,388</u>	<u>\$ (150,956)</u>	(6.4)%

### *Assets*

Total assets decreased \$151 million from \$2.34 billion at June 30, 2004 to \$2.19 billion at June 30, 2005. This decrease consisted primarily of the following items:

Total cash and investments decreased \$93 million from \$754 million at June 30, 2004 to \$660 million at June 30, 2005. This decrease was the direct result of the Department using excess cash to redeem bonds.

Net receivables under contracts of sale decreased \$50.7 million from \$1.53 billion at June 30, 2004 to \$1.48 billion at June 30, 2005. This decrease was principally the result of the current low interest rate environment. During the fiscal year, many contract holders refinanced their loans to lower interest rates with other financial institutions.

All other receivables and assets decreased \$6.8 million from \$60.7 million at June 30, 2004 to \$53.9 million at June 30, 2005. This net decrease was primarily due to a reduction in the inventory of repossessed properties, a decrease in interest receivables brought about by the increased prepayments of higher yielding Contracts of Sale rates into lower yielding investments and a one-time receipt of \$6.4 million from the Life and Disability Program for the prior fiscal year. Without the one time receipt for the prior fiscal year, all other assets decreased \$364 thousand over the prior fiscal year.

### *Liabilities and Fund Equity*

Bonds payable and other payables and liabilities decreased \$131.5 million from \$2.09 billion at June 30, 2004 to \$1.96 billion at June 30, 2005. This net decrease was primarily the result of the early redemption of bonds using excess cash.

Fund equity decreased by \$19.4 million from \$249.3 million at June 30, 2004 to \$229.9 million at June 30, 2005 as a result of the excess of expenses over revenues of \$19.4 million.



The total asset to liability ratio for the Fund remained unchanged at 1.12 as of June 30, 2005 and June 30, 2004.

## Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2005 and June 30, 2004 (dollars in thousands) and the percentage change.

	2005	2004	Change	% Change
<b>PROGRAM OPERATIONS:</b>				
Interest revenues:				
Contracts of purchase	\$ 90,794	\$ 100,676	\$ (9,882)	(9.8)%
Investments and other	<u>21,254</u>	<u>25,837</u>	<u>(4,583)</u>	(17.7)%
Total program operating revenues	112,048	126,513	(14,465)	(11.4)%
Expenses:				
Interest expense	114,030	145,046	(31,016)	(21.4)%
Loan reserve change	<u>(416)</u>	<u>(1,993)</u>	<u>1,577</u>	(79.1)%
Total program operating expenses	<u>113,614</u>	<u>143,053</u>	<u>(29,439)</u>	(20.6)%
Excess of program operations expenses over program operations revenues	<u>(1,566)</u>	<u>(16,540)</u>	<u>14,974</u>	(90.5)%
<b>PROGRAM ADMINISTRATION:</b>				
Total program administration revenues	5,791	7,138	(1,347)	(18.9)%
Total program administration expenses	<u>24,395</u>	<u>20,715</u>	<u>3,680</u>	17.8 %
Excess of program operations expenses over program operations revenues	<u>(18,604)</u>	<u>(13,577)</u>	<u>(5,027)</u>	37.0 %
Gain on sale of repossessed property	<u>673</u>	<u>1,173</u>	<u>(500)</u>	(42.6)%
Excess of expenses over revenues	<u>\$ (19,497)</u>	<u>\$ (28,944)</u>	<u>\$ 9,447</u>	(32.6)%

### *Program Operations*

Interest revenue from contracts of purchase decreased by \$9.9 million from \$100.7 million for the year ended June 30, 2004 to \$90.8 million for the year ended June 30, 2005, principally due to the decline of the Program's loan portfolio.

Interest revenues on investments decreased by \$4.6 million from \$25.8 million for the year ended June 30, 2004 to \$21.2 million for the year ended June 30, 2005. This decrease was due to the current historically low interest rates of the State's Surplus Money Investment Fund, in which a majority of the program's cash is invested. Additionally, cash and investment balances decreased due to early redemption of bonds.

Interest expense decreased by \$31 million from \$145 million for the year ended June 30, 2004 to \$114 million for the year ended June 30, 2005. The decrease was due to the significant reduction of outstanding bonds as a result of early redemptions. In addition, the Department economically refunded \$144 million of bonds that resulted in debt service savings.

Net program operation results for fiscal year 2005 improved by \$15 million from a deficiency of \$16.5 million to a deficiency of \$1.5 million in fiscal years 2004 and 2005, respectively. The improvement was mainly due to reduced interest expenses and improved investment results.

### **Program Administration**

Program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance, other miscellaneous fees collected from program participants, rental income, and certain reimbursements of prior expenses, among others. Revenues decreased by \$1.3 million from \$7.1 million for the year ended June 30, 2004 to \$5.8 million for the year ended June 30, 2005. The decrease was mainly the result of fewer fees collected from a lower volume of loan originations.

Total program administration expenses increased \$3.7 million from \$20.7 million for the year ended June 30, 2004 to \$24.4 million for the year ended June 30, 2005. The increase was due to three factors: (1) Payroll and related expenses decreased by \$0.5 million as the Department cut staff levels, (2) General and administrative expenses decreased by \$0.8 million as many of the Department's cost control measures took effect and (3) The Self-Insured Life and Disability program contributed a \$5 million expense increase between the two fiscal years. The program produced a loss of \$0.8 million for fiscal year 2005 as compared to a profit of \$4.2 million for the prior fiscal year.

Gain on Sale of Repossessed Properties decreased \$0.5 million from the last fiscal year. This decrease was due to reduced sales of repossessed properties as the Department's holdings of these properties went from \$2.5 million as of June 30, 2004 to \$2.0 million as of June 30, 2005.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**BALANCE SHEETS**

**JUNE 30, 2006 AND 2005 (in thousands)**

	<b>2006</b>	<b>2005</b>
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents:		
Cash In State Treasury	\$ 9,333	\$ 11,395
State of California's Surplus Money Investment Fund	<u>437,041</u>	<u>526,651</u>
Total cash and cash equivalents	446,374	538,046
Receivables under contracts of purchase—net of allowance for uncollectible contracts of \$8,050 in 2006 and \$8,300 in 2005	1,503,803	1,477,228
Interest receivables:		
Contracts of purchase	6,664	7,046
State of California's Surplus Money Investment Fund	5,371	3,472
Other investments	551	527
Total interest receivables	<u>12,586</u>	<u>11,045</u>
Total current assets	1,962,763	2,026,319
NONCURRENT ASSETS:		
Investments:		
Guaranteed investment contracts	120,356	116,253
Insurance administrators	<u>6,324</u>	<u>6,050</u>
Total investments	126,680	122,303
Due from Veterans Debenture Revenue Fund	37,765	37,510
Other real estate owned, net of allowance for losses of \$151 in 2006 and \$351 in 2005	1,047	1,999
Land, improvements and equipment—net of accumulated depreciation of \$14,421 in 2006 and \$13,613 in 2005	1,720	2,497
Other	2,665	804
Total noncurrent assets	<u>169,877</u>	<u>165,113</u>
<b>TOTAL</b>	<b><u>\$2,132,640</u></b>	<b><u>\$2,191,432</u></b>
<b>LIABILITIES AND FUND EQUITY</b>		
CURRENT LIABILITIES:		
Bonds payable—current portion	\$ 139,555	\$ 79,660
Accrued interest and other liabilities	25,655	30,739
Due to other funds	<u>1,196</u>	<u>494</u>
Total current liabilities	166,406	110,893
NONCURRENT LIABILITIES:		
Bonds payable—noncurrent portion	1,728,923	1,834,116
Insurance claims payable and loss reserves	<u>14,008</u>	<u>16,591</u>
Total noncurrent liabilities	1,742,931	1,850,707
Total liabilities	1,909,337	1,961,600
FUND EQUITY—Unrestricted	<u>223,303</u>	<u>229,832</u>
<b>TOTAL</b>	<b><u>\$2,132,640</u></b>	<b><u>\$2,191,432</u></b>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY  
YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands)**

	<b>2006</b>	<b>2005</b>
PROGRAM OPERATIONS:		
Interest revenues:		
Contracts of purchase of properties	\$ 84,527	\$ 90,794
Investments and other	27,900	19,220
Transfers of revenue from Veterans Debenture Revenue Fund	<u>2,021</u>	<u>2,034</u>
Total program operations revenues	<u>114,448</u>	<u>112,048</u>
Expenses:		
Interest expense	111,434	114,030
Reversal of allowance for uncollectible contracts	<u>(450)</u>	<u>(416)</u>
Total program operations expenses	<u>110,984</u>	<u>113,614</u>
Excess of program operations expenses under (over) program operations revenue	<u>3,464</u>	<u>(1,566)</u>
PROGRAM ADMINISTRATION:		
Revenues:		
Loan fees	3,266	3,957
Other income	2,546	1,625
Net revenue—Fire and hazard insurance program	<u>2,321</u>	<u>209</u>
Total program administration revenues	<u>8,133</u>	<u>5,791</u>
Expenses:		
Payroll and related costs	10,985	12,500
General and administrative expenses	10,340	11,014
Net (revenue) expense—Self-insured life and disability insurance program	<u>(695)</u>	<u>881</u>
Total program administration expenses	<u>20,630</u>	<u>24,395</u>
Excess of program administration expenses over program administration revenues	<u>(12,497)</u>	<u>(18,604)</u>
NONOPERATING REVENUE—Gain on sale of repossessed property	<u>204</u>	<u>673</u>
Excess of revenues over expenses	(8,829)	(19,497)
TRANSFER FROM VETERANS INDEMNITY FUND (Note 12)	2,300	-
FUND EQUITY:		
Beginning of year	<u>229,832</u>	<u>249,329</u>
End of year	<u>\$ 223,303</u>	<u>\$ 229,832</u>

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,  
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS**

**YEARS ENDED JUNE 30, 2006 AND 2005 (in thousands)**

	<b>2006</b>	<b>2005</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Receipts from contractholders	\$ 11,229	\$ 10,986
Interest received	110,886	111,507
Interest payments	(112,750)	(113,440)
Payments to suppliers and employees	(32,293)	(27,222)
Other receipts (payments)	6,333	(1,003)
Net cash used for operating activities	<u>(16,595)</u>	<u>(19,172)</u>
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:</b>		
Proceeds from sales of bonds	56,050	162,600
Maturities of bonds payable	(79,660)	(79,285)
Early redemption of bonds payable	(22,780)	(208,560)
Net (increase) decrease in Due from Veterans Debenture Revenue Fund	<u>(255)</u>	<u>22</u>
Net cash used for noncapital financing activities	<u>(46,645)</u>	<u>(125,223)</u>
<b>CASH FLOWS PROVIDED BY RELATED FINANCING ACTIVITIES—Transfer from Disaster Indemnity Fund (Note 12)</b>	<u>2,300</u>	<u>-</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Net (increase) decrease in receivables under contracts of purchase	(26,325)	50,962
Net (increase) decrease in investment securities	(4,377)	39,437
Purchase of land, improvements and equipment	<u>(30)</u>	<u>-</u>
Net cash (used in) provided by investing activities	<u>(30,732)</u>	<u>90,399</u>
<b>DECREASE IN CASH IN STATE TREASURY</b>	<b>(91,672)</b>	<b>(53,996)</b>
<b>CASH IN STATE TREASURY:</b>		
Beginning of year	<u>538,046</u>	<u>592,042</u>
End of year	<u><u>\$ 446,374</u></u>	<u><u>\$ 538,046</u></u>
<b>RECONCILIATION OF OPERATING INCOME TO NET CASH USED FOR OPERATING ACTIVITIES:</b>		
Deficiency of revenues under expenses	\$ (8,829)	\$ (19,497)
Adjustments to reconcile to net cash used by operating activities:		
Bond amortization	1,092	(533)
Reversal of allowance for uncollectible contracts	(450)	(416)
Depreciation	807	901
Gain on sale of repossessed property	(204)	(673)
Effect of changes in assets and liabilities:	-	-
Increase in interest receivable—State of California's Surplus Money Investment Fund	(1,899)	(1,200)
(Increase) decrease in interest receivable—other investments	(24)	259
Decrease in interest receivable—contracts of purchase	382	400
Decrease in other real estate owned	1,356	1,310
Decrease (increase) in other assets	(1,861)	5,958
Decrease in accrued interest and other liabilities	(5,084)	(2,470)
(Decrease) increase in due to other funds	702	(353)
Decrease in insurance claims payable and loss reserves	<u>(2,583)</u>	<u>(2,858)</u>
<b>NET CASH USED FOR OPERATING ACTIVITIES</b>	<u><u>\$ (16,595)</u></u>	<u><u>\$ (19,172)</u></u>

See notes to financial statements.

# VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

## NOTES TO FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2006 AND 2005

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### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization and Description**—The California Department of Veterans Affairs (the “Department”) is a separate legal entity and a Cabinet level agency of the State of California. A seven-member California Veterans Board (the “Board”) has policy oversight of the operations of the Department, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the “Fund”) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the Legislature are used for contract loans to veterans. Expenses are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

**Basis of Accounting**—The Fund has been classified as a proprietary fund for accounting purposes. Revenues are recorded when earned and expenses are recognized as incurred.

**Accounting and Reporting Standards**—The Fund follows the *Standards of Governmental Accounting and Financial Reporting*, as promulgated by the *Governmental Accounting Standards Board* (“GASB”). The Fund has adopted the option under Governmental Accounting Standards Board Statement No. 20 (GASB No. 20), *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Funds Accounting*, which allows the Fund to apply all GASB pronouncements and only *Financial Accounting Standards Board* (“FASB”) pronouncements which date prior to November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board (“FASB”) Statements and Interpretations, Accounting Principles Board (“APB”) Opinions, and Accounting Research Bulletins (“ARBs”) of the Committee on Accounting Procedures.

**Use of Estimates in the Preparation of Financial Statements**—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Investments**—The Department reports all investments at fair value except for certain nonparticipating fixed interest investment contracts which are valued using cost based measures. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund (“SMIF”). Uncommitted bond proceeds for loans to veterans are reflected in the balance sheet within the investments balance.

**Receivables under Contracts of Purchase**—Receivables under contracts of purchase consist of the remaining contract principal balance net of the reserve for uncollectible accounts.

**Allowance for Uncollectible Contracts**—The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers’ ability to repay the obligation.

**Contract Guarantees and Primary Mortgage Insurance**—The Department collects a contract guarantee fee on all contracts with down payments less than 20%. Such contracts are classified as high loan to value (“HLTV”) contracts. For eligible borrowers, the fee is used to purchase contract guarantees from the U.S. Department of Veterans Affairs (“USDVA”) or primary mortgage insurance. For certain HLTV contracts not eligible for USDVA guarantees, the Fund purchases primary mortgage insurance (“PMI”) from Radian Guaranty Inc., formerly, the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV contracts, not covered by USDVA guarantees, subject to an aggregate 2% deductible. The Department is responsible for any losses not covered by the USDVA guarantees or the PMI.

**Other Real Estate Owned**—Real estate acquired by repossession is carried at the lower of the contract balance or its net realizable value. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses.

**Insurance Claims Payable and Loss Reserves**—Insurance claims payable and loss reserves include unpaid claims, incurred but not reported claims and loss reserves for the fire and hazard insurance plan and the remaining benefits payable under the Department’s former self-insured life and disability protection plan.

**Fire and Hazard Insurance**—This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred and the change in loss reserves is included as a net amount in the statement of revenues, expenses and changes in retained earnings.

**Self-Insured Life and Disability Protection Plan**—Beginning in 1984, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. This plan was terminated June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan which include future disability and life benefits were derived from an actuarial evaluation performed in 2001 that is updated internally on an annual basis. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability, prepayment, and a long-term discount rate of 7%.

***Amortization of Bond Premiums, Discounts and Issuance Costs***—Premiums and discounts arising from the issuance of bonds and expenses incurred in connection with the issuance of bonds are capitalized and amortized using the monthly amortization method, which approximates the interest method.

## 2. CASH AND INVESTMENTS

Cash in the State Treasury represents amounts held in the Fund’s general operating accounts with the State Treasury. These monies are pooled with the monies of other State agencies and invested by the State Treasurer’s office. These assets are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California’s Surplus Money Investment Fund (“SMIF”), and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law.

The Fund’s investment agreements totaling \$120,356,000 and \$116,253,000 as of June 30, 2006 and 2005, respectively, are carried at cost. The interest rates on investment agreements are fixed and range from 5.30% to 6.46%. The investment agreements expire from 2006 to 2032.

The Fund’s investments in the amounts administered by the insurance company are categorized as risk category 1, which is defined by Governmental Accounting Standards Board Statement No. 3 (“GASB Statement No. 3”) as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund’s name. In accordance with GASB Statement No. 3, the Fund’s investments held in the State of California’s Surplus Money Investment Fund and the investment agreements are not categorized as to risk.

The Fund’s investments at June 30, 2006 and 2005 are as follows (in thousands):

	2006	2005
<b>Category 1</b>		
Amounts held in trust fund with insurance administrators	\$ 6,324	\$ 6,050
<b>Investments Not Subject to Categorization</b>		
SMIF (at cost)	437,041	526,652
Investment agreements (at cost)	120,356	116,253

## 4. RECEIVABLES UNDER CONTRACTS OF PURCHASE

The Fund retains title to all real property subject to contracts of purchase until the contract is satisfied. The veteran’s contracts have original terms of 25-30 years and bear interest at rates of 4.25% to 9.75%, depending on the age and type of contract and the classification of the contract holder.



## 5. LAND, IMPROVEMENTS, AND EQUIPMENT

As of June 30, 2006, land, improvements and equipment consisted of the following:

	2006	2005
Land	\$ 443,531	\$ 443,531
Buildings	12,409,774	12,409,774
Equipment	<u>3,287,545</u>	<u>3,257,564</u>
	16,140,850	16,110,869
Less accumulated depreciation	<u>(14,420,881)</u>	<u>(13,613,428)</u>
Land, improvements, and equipment—net	<u>\$ 1,719,969</u>	<u>\$ 2,497,441</u>

## 6. BONDS PAYABLE

At June 30, 2006 and 2005, bonds payable included the following (in thousands):

	2006	2005
General obligation bonds of the State of California, annual interest rates from 4.2% to 11.0% due in varying annual installments through 2037 (subject to varying redemption provisions)	\$ 1,279,590	\$ 1,356,315
Home purchase revenue bonds, annual interest rates from 2.14% to 6.15%, due in varying annual installments through 2028 (subject to varying redemption provisions)	543,360	569,075
Commercial Paper, due to the State of California, due in full November 2006	<u>56,050</u>	<u>-</u>
Total	1,879,000	1,925,390
Less:		
Discounts	(501)	(540)
Unamortized bond origination costs	(9,392)	(10,253)
Unamortized bond redemption premiums	<u>(629)</u>	<u>(821)</u>
Total	1,868,478	1,913,776
Less—current portion	<u>139,555</u>	<u>79,660</u>
Noncurrent portion	<u>\$ 1,728,923</u>	<u>\$ 1,834,116</u>

A summary of debt service requirements for the next five years and to maturity is as follows (in thousands):

<b>Fiscal Year Ending June 30</b>	<b>Principal</b>	<b>Interest</b>
2007	\$ 83,505	\$ 102,230
2008	90,600	94,387
2009	87,430	86,611
2010	68,495	79,431
2011	35,490	74,258
2012-2016	288,210	333,693
2017-2021	410,395	239,718
2022-2026	407,365	141,671
2027-2031	241,155	56,814
2032-2037	<u>110,305</u>	<u>11,238</u>
Total	<u>\$ 1,822,950</u>	<u>\$ 1,220,051</u>

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. Authorized and unissued bonds under the Veterans Bond Acts of 1996 and 2000 were \$485,585,000 at June 30, 2006 and 2005.

Home Purchase Revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Veterans Farm and Home Building Fund of 1943 and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the \$1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 2006 and 2005, authorized and unissued revenue bonds were \$956,640,000 and \$930,925,000, respectively.

During fiscal year 1998, the Department amended the revenue bond resolution provisions regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to at least three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B and C Bonds, and 2001 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds, and for series 2002 an amount equal to five percent of the outstanding principal amount. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Fund Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 2006 and 2005, the total

assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the California Department of Veterans Affairs.

## 7. BOND REFUNDING

During fiscal year 2006, the Department did not issue any new or refunding bonds.

In fiscal year 2005, the Department issued General Obligation bonds totaling \$221,475,000 and Home Purchase Revenue bonds totaling \$42,600,000 with an average interest rate of 4.80%. Bond proceeds of \$101,465,000 from the General Obligation bond issues were used to refund previously issued General Obligation bonds in the same amount. Bond proceeds of \$42,600,000 from the Revenue bond issues were used to refund previously issued Revenue bonds in the same amount. The Department decreased its total debt service payments over the next fifteen years by approximately \$24,319,000 and realized an economic gain (difference between the present values of the debt service payment on the old and new debt adjusted by cost of issuance) of approximately \$15,776,000 in connection with the refunding.

## 8. FIRE AND HAZARD INSURANCE

Fire and hazard insurance coverage is provided on behalf of contract holders for substantially all properties subject to contracts of sale. The program is funded by amounts charged to contract holders which are considered appropriate to cover losses incurred, premiums paid for excess insurance coverage and administration fees. From the amounts charged to contract holders, the Department pays losses up to \$2,500,000 per occurrence or \$13,000,000 per policy year. Coverage in excess of the above amounts is provided by several insurance carriers up to an additional \$50,000,000. The loss reserve is based on the third party administrator's estimate of incurred but not reported claims based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses and change in loss reserves for the year ended June 30, 2006 and 2005, was as follows (in thousands):

	2006	2005
Amounts charged to contract holders	\$ 7,862	\$ 5,992
Less:		
Increase in estimated loss reserve	(749)	(24)
Claims loss expense	(2,954)	(4,734)
Master policy premium	(949)	(565)
Administrative fees	(581)	(460)
Third party contract-replacement value project	(308)	-
Net revenue—Fire and hazard insurance program	<u>\$ 2,321</u>	<u>\$ 209</u>

## 9. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. Except for existing contract holders receiving benefits at that date, the self-insured life and disability protection plan was replaced by existing life and disability insurance plans provided by commercial insurers.

As of June 30, 2006, the Department remains self-insured for approximately 325 remaining contract holders. Under the provisions of the self-insured plan benefits continue until the beneficiary returns to active employment, dies or their contract is paid off. Loss reserves for these obligations have been actuarially determined.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverages continue as obligations of the self-funded life and disability protection plan for the years ended June 30, 2006 and 2005, was as follows (in thousands):

	2006	2005
Claims expenses:		
Life insurance program	\$ 282	\$ 336
Disability insurance program	<u>2,693</u>	<u>3,225</u>
Total claims expenses	2,975	3,561
Decrease in estimated loss reserves	<u>(3,600)</u>	<u>(2,600)</u>
Net claims (revenue) expense and change in loss reserves	<u>(625)</u>	<u>961</u>
Plan revenues:		
Life insurance program	(29)	(38)
Disability insurance program	<u>(71)</u>	<u>(82)</u>
Total	(100)	(120)
Administrative fees	<u>30</u>	<u>40</u>
Net (revenue) expense—		
Self-insured life and disability insurance program	<u>\$ (695)</u>	<u>\$ 881</u>

## 10. COMMITMENTS AND CONTINGENCIES

As of June 30, 2006 and 2005, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately \$124,702,169 and \$98,251,372, respectively.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 2006 and 2005, was \$371,397 and \$361,361, respectively. Lease terms generally range from five to ten years with options to renew for additional periods. As of June 30, 2006, minimum annual rentals under operating leases are as follows (in thousands):

2007	\$ 111
2008	113
2009	100
2010	<u>47</u>
Total	<u>\$ 371</u>

## 11. RETIREMENT PLAN

**Plan Description**—The Fund contributes to the Public Employees’ Retirement Fund (“PERF”) as part of the State of California, the primary government. The PERF is a cost-sharing multiple-employer defined benefit pension plan administered by the California Public Employment Retirement System (“CalPERS”). CalPERS provides retirement, death, disability, and post retirement health care benefits to members as established by state statute. CalPERS issues a publicly available Comprehensive Annual Financial Report (“CAFR”) that includes financial statements and required supplementary information for the Public Employees’ Retirement Fund. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the internet at [www.calpers.ca.gov](http://www.calpers.ca.gov).

**Funding Policy**—Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on 5% of compensation in excess of \$513 each month.

Contributions by the Department to the Plan for the years ended June 30, 2006 and 2005 were approximately \$1,199,000 and \$1,395,000, or approximately 15.3% and 16.3% of participants’ salaries, respectively.

**Annual Pension Cost**—For Department’s annual pension cost was equal to the Department’s required and actual contributions. Required contribution is determined by actuarial valuation using the entry age normal actuarial cost method. The most recent actuarial valuation available is as of June 30, 2003 which actuarial assumptions included (a) 8.25% investment rate of return compounded annually, (b) projected salary increases that vary based on duration of service, and (c) overall payroll growth factor of 3.75% annually. Both (a) and (b) included an inflation component of 3.5% and a .25 percent per annum productivity increase in consumption. The actuarial value of CalPERS assets attributable to the Department was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a two to five-year period.

### *Three-Year Trend Information for the Plan—*

Three-Year Fund Trend Information			
Fiscal Year End	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
June 30, 2004	\$ 1,349,000	100%	\$ -
June 30, 2005	\$ 1,395,000	100%	\$ -
June 30, 2006	\$ 1,199,000	100%	\$ -

The most recent actuarial valuation of CalPERS indicated that there was a deficiency of assets over accrued liabilities for benefits due to active and inactive employees and retirees in the plan. The amount of the under funded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due is presented in the June 30, 2005 CalPERS CAFR.

## **12. TRANSFER FROM DISASTER INDEMNITY FUND**

The Disaster Indemnity Fund ("Disaster Fund"), a separate fund of the Department, accounts for coverage provided to contract holders for damage caused by flood, earthquake and other perils. During the year ended June 30, 2006, the Department transferred \$2,300,000 from the Disaster Fund to the Fund, which represents the return of the original transfer of monies in 1986 out of the Fund, which were used by the Disaster Fund to mitigate the increased cost of premiums for excess disaster insurance, as well as unusually large losses experienced by the Disaster Fund during 1986.

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**EXHIBIT 2**  
**CERTAIN DEPARTMENT FINANCIAL INFORMATION**  
**AND OPERATING DATA**

**Contracts of Purchase**

Set forth below is certain financial information regarding Contracts of Purchase.

***Existing Contracts of Purchase***

The following charts describe the current loan to value ratios and geographic distribution of Contracts of Purchase financed under the Program as of June 30, 2006 using proceeds of Veterans G.O. Bonds, Revenue Bonds and other amounts under the 1943 Fund.

**Current Loan-to-Value Ratio of Contracts of Purchase<sup>(1)(2)</sup>**

	<u>Uninsured</u>	<u>Radian Insured<sup>(5)</sup></u>	<u>Radian Insured<sup>(6)</sup></u>	<u>VA Guaranteed</u>	<u>Total</u>
<b>Single Family Homes</b>					
Less than 30% LTV	\$ 78,006	\$ 705	\$ 130	\$ 237	\$ 79,078
30-49% LTV .....	138,979	4,230	640	943	144,792
50-59% LTV .....	94,933	3,845	487	347	99,612
60-69% LTV .....	129,512	19,810	1,874	2,665	153,861
70-79% LTV .....	194,666	69,745	12,908	8,920	286,239
Sub-total .....	\$ 636,096	\$ 98,335	\$ 16,039	\$ 13,112	\$ 763,582
80-84% LTV .....	\$ 11,187	\$ 30,849	\$ 42,368	\$ 15,545	\$ 99,949
85-89% LTV .....	9,414	19,595	101,652	37,062	167,723
90-94% LTV .....	11,507	9,470	204,797	48,667	274,441
95-97% LTV .....	2,296	-	30,557	15,607	48,259
Sub-total .....	\$ 34,203	\$ 59,914	\$ 379,375	\$ 116,881	\$ 590,373
<b>Greater than 97% LTV</b>	\$ 2,295	\$ -	\$ 680	\$ 98,188	\$ 101,163
<b>Other Property Types</b>					
Farms .....	\$ 3,500	\$ 180	\$ 561	\$ -	\$ 4,241
Mobile Homes in Parks .....	12,056	-	16,431	-	28,487
Homes under Construction	15,060	44	613	-	15,717
Sub-total .....	\$ 30,616	\$ 224	\$ 17,605	\$ -	\$ 48,445
<b>Special Status Contracts of Purchase</b>					
Real Estate Owned <sup>(3)</sup> .....	\$ 590	\$ 74	\$ 343	\$ 200	\$ 1,207
Disability Program <sup>(4)</sup> .....	7,825	738	-	-	8,563
Sub-total .....	\$ 8,415	\$ 812	\$ 343	\$ 200	\$ 9,770
<b>Total Portfolio .....</b>	<b>\$ 711,625</b>	<b>\$ 159,285</b>	<b>\$ 414,042</b>	<b>\$ 228,381</b>	<b>\$ 1,513,333</b>

<sup>(1)</sup> Amounts in thousands.

<sup>(2)</sup> LTV based on current Contracts of Purchase balance divided by original appraised value of the property, except when the Department updates the appraised value of the home when the veteran applies for a home improvement loan. In such cases, the LTV is calculated with the new appraised value.

<sup>(3)</sup> Repossessed properties and delinquent Contracts of Purchase carried as REO on financial statements.

<sup>(4)</sup> Contracts of Purchase where payments are made on behalf of veterans by the Department's life and disability coverage plan.

<sup>(5)</sup> The policy was executed on February 28, 1998.

<sup>(6)</sup> The policy was executed on July 1, 2000.

### Geographic Distribution of Contracts of Purchase

<u>County</u>	<u>Approximate Current Contract Balance as of June 30, 2006</u>
Riverside .....	\$ 157,184,669
Sacramento.....	132,698,392
San Diego.....	129,739,942
San Bernardino .....	112,102,382
Los Angeles .....	96,390,474
Kern.....	94,059,623
Fresno.....	91,729,474
Shasta .....	51,245,231
Solano .....	39,215,549
San Joaquin .....	37,405,130
Placer .....	35,492,758
Orange.....	32,752,434
Contra Costa .....	22,439,477
Other Northern California Counties .....	258,413,839
Other Central California Counties.....	181,612,504
Other Southern California Counties .....	40,851,327
Statewide--California.....	<u>\$ 1,513,333,208</u>

### Contracts of Purchase Origination and Principal Repayment Experience

The following tables represent, respectively, a historical picture of Contract of Purchase originations since the 1985 fiscal year and selected principal repayments with respect to Contracts of Purchase since the 1990 fiscal year.

### New Contracts of Purchase During the Fiscal Year

<u>Fiscal Year Ending June 30</u>	<u>Veterans G.O. Bonds</u>		<u>Unrestricted Funds</u>		<u>Revenue Bonds</u>		<u>Total</u>	
	<u>Number<sup>(1)</sup></u>	<u>Amount</u>	<u>Number<sup>(1)</sup></u>	<u>Amount</u>	<u>Number<sup>(1)</sup></u>	<u>Amount</u>	<u>Number<sup>(1)</sup></u>	<u>Amount</u>
1990.....	2,097	\$ 187,445,600			522	\$ 38,150,800	2,619	\$ 225,596,400
1991.....	1,927	200,393,500			359	29,189,600	2,286	229,583,100
1992.....	1,086	111,600,500			388	34,671,600	1,474	146,272,100
1993.....	740	94,417,100			286	27,443,800	1,026	121,860,900
1994.....	843	117,213,779			337	34,740,536	1,180	151,954,315
1995.....	2,109	286,178,376			822	84,860,894	2,931	371,039,270
1996.....	762	107,751,444			222	22,723,617	984	130,475,061
1997.....	766	118,344,636			201	21,853,933	967	140,198,569
1998.....	615	99,224,002	188	\$ 17,716,376	164	18,871,066	967	135,811,444
1999.....	758	129,521,359	575	92,728,280	274	33,284,343	1,607	255,533,982
2000.....	1,045	185,180,534	1,725	333,328,690	708	92,214,409	3,478	610,723,633
2001.....	844	135,498,480	1,211	232,445,146	697	101,175,512	2,752	469,119,138
2002.....	334	57,109,103	416	74,798,670	204	27,178,525	954	159,086,298
2003.....	357	68,105,508	508	99,179,927	123	16,285,625	988	183,571,060
2004.....	444	97,223,818	1173	274,187,085	165	26,109,792	1782	397,520,696
2005.....	285	72,958,181	702	181,075,275	178	37,152,048	1165	291,185,504
2006.....	198	48,999,641	898	230,993,270	5	831,638	1101	280,824,549

<sup>(1)</sup> Number of new Contracts of Purchase does not include home improvement loans.



**Selected Principal Flows with respect to Contracts of Purchase  
Funded by both Veterans G.O. Bonds and Revenue Bonds  
(Dollar Amounts in Thousands)**

<b>Fiscal Year Ending June 30</b>	<b>Contracts Funded During Year</b>	<b>Contract Prepayments During Year</b>	<b>Other Principal Receipts-Losses During Year</b>	<b>Contract Balance at End of Year</b>	<b>Average Rate on all Outstanding Contracts</b>	<b>Average of Monthly FHLMC 30-year Conventional Loan Rate</b>	<b>Annual Average Prepayment Rate</b>	<b>Annual Average Origination Rate</b>
<b>Principal Flows</b>					<b>Rates</b>			
1990 .....	\$ 225,596	\$ 232,085	\$ 96,639	\$ 3,037,766	8.0%	10.1%	7.5%	7.3
1991 .....	229,583	191,895	92,722	2,982,732	8.0	9.9	6.4	7.6
1992 .....	146,272	246,150	92,975	2,789,879	8.0	9.0	8.5	5.1
1993 .....	121,861	273,817	105,629	2,532,294	8.0	8.0	10.3	4.6
1994 .....	151,954	359,749	98,773	2,225,726	8.0	7.3	15.1	6.4
1995 .....	371,039	111,984	74,706	2,410,075	7.8	8.7	4.8	16.0
1996 .....	130,475	141,767	92,521	2,306,262	8.0	7.5	6.0	5.5
1997 .....	140,199	111,254	106,027	2,229,180	8.0	7.9	4.9	6.2
1998 .....	135,812	172,134	94,106	2,098,752	7.7	7.2	8.0	6.3
1999 .....	255,534	183,776	101,254	2,069,256	6.9	6.9	8.8	12.3
2000 .....	610,724	138,401	106,522	2,435,056	6.8	8.1	6.1	27.1
2001 .....	469,119	189,902	91,033	2,623,241	6.8	7.5	7.5	18.5
2002 .....	158,982	330,068	86,556	2,365,599	6.8	6.9	13.2	6.4
2003 .....	183,496	701,785	74,643	1,772,667	6.7	5.9	33.9	8.9
2004 .....	397,521	576,907	53,833	1,539,448	6.3	5.9	34.8	24.0
2005 .....	291,186	272,044	70,564	1,488,026	5.9	5.8	18.0	19.2
2006 .....	280,825	204,037	51,481	1,513,333	5.8	6.2	13.6	18.7
	\$ 4,300,178	\$ 4,437,755	\$ 1,489,984					

**Reservation rates on new Contracts of Purchase for period:**

<b>Period</b>	<b>Veterans G.O. Bonds<sup>(1)</sup></b>	<b>Unrestricted Funds</b>	<b>Revenue Bonds</b>
Prior to January 1, 1999, substantially all newly originated Contracts have the same rate as the then outstanding Contracts.			
January 1, 1999 thru June 30, 2000	6.65%	6.65%	5.95%
July 1, 2000 thru February 28, 2001	7.50%	7.95%	6.95%
March 1, 2001 thru May 31, 2001	6.50%	7.95%	6.40%
June 1, 2001 thru August 31, 2001	6.50%	7.10%	6.40%
September 1, 2001 thru April 1, 2002	6.25%	6.50%	6.00%
April 2, 2002 thru July 31, 2002	5.90%	5.50%	5.80%
August 1, 2002 thru December 1, 2002	5.50%	6.00%	5.80%
December 2, 2002 thru June 15, 2003	4.99%	5.40%	5.25%
June 16, 2003 thru September 1, 2003	4.25%	4.50%	4.50%
September 1, 2003 thru September 15, 2003	4.25%	4.99%	4.50%
September 16, 2003 thru May 5, 2004	4.50%	4.99%	4.50%
May 6, 2004 thru June 1, 2004	4.75%	5.25%	4.75%
June 2, 2004 thru December 13, 2004	4.95%	5.50%	5.10%
December 14, 2004 thru April 3, 2005	4.95%	5.50%	5.50%
April 4, 2005 through December 9, 2005	5.15%	5.50%	5.50%
December 10, 2005 through February 5, 2006	5.50%	5.50%	5.50%
February 6, 2006 through March 14, 2006	5.70%	5.70%	5.70%
March 15, 2006 through April 25, 2006	6.00%	6.00%	6.00%
April 26, 2006 through July 5, 2006	6.25%	6.25%	6.25%
July 6, 2006 through present	6.50%	6.50%	6.50%

<sup>(1)</sup> Rates for contracts of purchase for mobile home in parks shall be 1% higher than the applicable established rates.

## Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments

The following table shows amounts expected to be available to fund Contracts of Purchase from Veterans G.O. Bonds and Revenue Bonds. Additional moneys may become available to finance Contracts of Purchase through the future issuances of Veterans G.O. Bonds and Revenue Bonds. The Department has full discretion to use moneys available from prior, current or future bond issues in any order of priority it chooses. As of June 30, 2006, the Department had 457 pending applications for Contracts of Purchase in the aggregate amount of approximately \$124,702,000.

### Amounts Expected to be Available to Fund Purchase <sup>(1)</sup>

	Unrestricted Moneys			Qualified Veterans' Mortgage Bond Proceeds			Current or expected Investment	Contracted Investment Rate (%)
	On Deposit on June 30, 2006	Amounts Expected to be Deposited or Applied to Contracts through November 30, 2006	Amount Expected to be on Deposit November 30, 2006	Amount On Deposit on June 30, 2006	Amounts Expected to be Deposited or Applied to Contracts through November 30, 2006	Amount Expected to be on Deposit November 30, 2006		
<b>Veterans G.O. Bond Proceeds and Recycling Subaccounts</b>								
Unrestricted .....	\$ 19,828	\$ 286,495 <sup>(4)</sup>	\$ 306,324	\$ 0	\$ 0	\$ 0	SMIF <sup>(7)</sup>	Variable
QVMB Reimbursement	24,070 <sup>(2)</sup>	(24,070) <sup>(5)</sup>	0	0	0	0	SMIF	Variable
QMB Reimbursement	15,340 <sup>(3)</sup>	(10,000) <sup>(5)</sup>	5,340	0	0	0	SMIF	Variable
Series CC/CD .....	0	0	0	0	50,275 <sup>(6)</sup>	50,275	<sup>(8)</sup>	
Other G.O. Bond Series	0	0	0	8,214	0	8,214	SMIF	Variable
<b>Total.....</b>	<b>\$ 59,238</b>	<b>\$ 252,425</b>	<b>\$ 311,663</b>	<b>\$ 8,214</b>	<b>\$ 50,275</b>	<b>\$ 58,489</b>		
<b>Revenue Bond Proceeds and Recycling Subaccounts</b>								
1991 Series A .....	\$ 12,710	\$ (10,000) <sup>(5)</sup>	\$ 2,710				BLB <sup>(9)</sup>	6.06
1999 Series A/B .....	272	746	1,017				BLB <sup>(10)</sup>	5.30
2001 Series A .....	7,300	(5,794)	1,506				BLB <sup>(11)</sup>	5.67
2003 Series A .....	6,716	(6,716)	0				SMIF	Variable
2005 Series A .....	552	0	552				SMIF	Variable
<b>Total.....</b>	<b>\$ 27,551</b>	<b>\$ (21,764)</b>	<b>\$ 5,786</b>					
<b>Grand Total</b>	<b>\$ 86,789</b>	<b>\$ 230,661</b>	<b>\$ 317,450</b>	<b>\$ 8,214</b>	<b>\$ 50,275</b>	<b>\$ 58,489 <sup>(12)</sup></b>		

<sup>(1)</sup> 000's omitted.

<sup>(2)</sup> Funds currently being utilized to fund contracts in anticipation of reimbursement from proceeds of the 2006 G.O. Bonds.

<sup>(3)</sup> Funds currently being utilized to fund contracts in anticipation of reimbursement from proceeds of future issuance of Qualified Mortgage Bonds.

<sup>(4)</sup> Reflects transfers from various Revenue Subaccounts, transfers from other Recycling Subaccounts, reimbursement proceeds of the 2006 G.O. Bonds, and amounts to be made available upon conversion of the 2003 Series A Bonds to fixed rate.

<sup>(5)</sup> Reflects certain transfers to the Unrestricted Recycling Subaccount.

<sup>(6)</sup> Reflects proceeds of the 2006 G.O. Bonds.

<sup>(7)</sup> A portion of these funds may be placed in an investment agreement in connection with the issuance of the 2006 G.O. Bonds.

<sup>(8)</sup> To be determined in connection with the issuance of the 2006 G.O. Bonds.

<sup>(9)</sup> Investment agreement maturing December 1, 2009 with Bayerische Landesbank Girozentrale.

<sup>(10)</sup> Investment agreement maturing December 1, 2028 with Bayerische Landesbank Girozentrale.

<sup>(11)</sup> Investment agreement maturing December 1, 2011 with Bayerische Landesbank Girozentrale.

<sup>(12)</sup> As of June 30, 2006, the Department had 457 pending applications for Contracts of Purchase in the aggregate amount of approximately \$124,702,000.

## Cancellations and Delinquencies

Set forth in the table below is a comparative chart of delinquent, cancelled and repossessed Contracts of Purchase and certain comparative information regarding USDVA guaranteed loans during the same period.

	<u>1998<sup>(1)</sup></u>	<u>1999<sup>(1)</sup></u>	<u>2000<sup>(2)</sup></u>	<u>2001<sup>(2)</sup></u>	<u>2002<sup>(2)</sup></u>	<u>2003<sup>(2)</sup></u>	<u>2004<sup>(2)</sup></u>	<u>2005<sup>(2)</sup></u>	<u>2006<sup>(3)</sup></u>
<b>Percentage of Number of Contracts of Purchase</b>									
<b>Delinquent</b>									
30-60 days <sup>(6)</sup> .....	-- <sup>(8)</sup>	-- <sup>(8)</sup>	3.91% <sup>(7)</sup>	4.24% <sup>(7)</sup>	3.52% <sup>(7)</sup>	3.13% <sup>(7)</sup>	2.97% <sup>(7)</sup>	3.18% <sup>(7)</sup>	2.93% <sup>(7)</sup>
60+ days <sup>(6)</sup> .....	-- <sup>(8)</sup>	-- <sup>(8)</sup>	2.88% <sup>(7)</sup>	3.16% <sup>(7)</sup>	2.43% <sup>(7)</sup>	2.03% <sup>(7)</sup>	1.43% <sup>(7)</sup>	1.48% <sup>(7)</sup>	0.85% <sup>(7)</sup>
Cancelled Contracts and Real Estate in inventory <sup>(4)</sup> ..	-- <sup>(8)</sup>	-- <sup>(8)</sup>	0.72% <sup>(7)</sup>	0.69% <sup>(7)</sup>	0.41% <sup>(7)</sup>	0.32% <sup>(7)</sup>	0.22% <sup>(7)</sup>	0.12% <sup>(7)</sup>	0.10% <sup>(7)</sup>
<b>USDVA Guaranteed Loans<sup>(5)</sup></b>									
<b>Percentages in U.S.</b>									
<b>Delinquent</b>									
30-60 days.....	4.45%	4.35%	4.19%	4.71%	4.87%	4.83%	4.53%	4.49%	3.81%
60+ days.....	2.35%	2.26%	2.25%	2.65%	2.85%	3.15%	2.90%	3.10%	2.53%
Foreclosures in inventory .....	1.77%	1.82%	1.44%	1.20%	1.72%	1.49%	1.45%	1.50%	1.10%
<b>Percentages in California</b>									
<b>Delinquent</b>									
30-60 days.....	4.28%	4.13%	4.05%	4.57%	4.57%	4.67%	4.09%	3.52%	2.92%
60+ days.....	2.61%	2.45%	2.27%	2.49%	2.57%	2.79%	2.34%	2.11%	1.30%
Foreclosures in inventory .....	2.92%	2.28%	1.39%	0.93%	1.12%	0.93%	0.69%	0.60%	0.36%

<sup>(1)</sup> As of June 18 for Department data and as of June 30 for USDVA data.

<sup>(2)</sup> As of June 30 for the Department and for USDVA data.

<sup>(3)</sup> As of June 30, 2006 for the Department and for USDVA data.

<sup>(4)</sup> Bankruptcies are included in cancelled Contracts statistics and do not exceed in any period more than 10% of total cancellations and bankruptcy category. Federal bankruptcy law precludes repossession action of Contracts of Purchase when veteran is in bankruptcy proceedings until the automatic stay is lifted.

<sup>(5)</sup> Source: National Delinquency Survey published by the Mortgage Bankers Association of America.

<sup>(6)</sup> As of the June 30, 1999 installation of the Integrated Loan Processing and Financial Information System, the Department reports delinquencies on a basis consistent with industry standards.

<sup>(7)</sup> The Department has adjusted the criteria used to identify delinquent contracts from \$25 or more delinquent to over \$3 delinquent. The data below represents the breakout of delinquent, repayment/forbearance agreements and cancelled contracts and real estate in inventory. These figures include contracts that were the subject of forbearance or repayment agreements between the Department and the contract holder.

	<u>2002<sup>(2)</sup></u>	<u>2003<sup>(2)</sup></u>	<u>2004<sup>(2)</sup></u>	<u>2005<sup>(2)</sup></u>	<u>2006<sup>(3)</sup></u>
<b>Percentage of Number of Contracts of Purchase</b>					
<b>Delinquent, Repayment/Forbearance</b>					
<b>Agreements, and Cancelled Contracts and Real</b>					
<b>Estate in inventory</b>					
30-60 days (Delinquent).....	2.95%	2.77%	2.72%	2.96%	2.84%
30-60 days (Repayment/Forbearance Agreement) ..	0.57%	0.36%	0.25%	0.22%	0.09%
<b>Total</b> .....	3.52%	3.13%	2.97%	3.18%	2.93%
60+ days (Delinquent).....	1.38%	1.32%	1.08%	1.17%	0.75%
60+ days (Repayment/Forbearance Agreement) .....	1.05%	0.71%	0.35%	0.31%	0.10%
<b>Total</b> .....	2.43%	2.03%	1.43%	1.48%	0.85%
Cancelled Contracts and Real Estate in inventory ....	0.39%	0.31%	0.19%	0.12%	0.10%
"Repayment/Forbearance Agreement" .....	0.02%	0.01%	0.03%	0.00%	0.00%
<b>Total</b> .....	0.41%	0.32%	0.22%	0.12%	0.10%

<sup>(8)</sup> The data below represents the Department's reporting method prior to the implementation of the Integrated Loan Processing and Financial Information System. The Department's prior reporting system did not treat contracts that were the subject of forbearance or repayment agreements between the Department and the contract holder as delinquent. As a result, contracts that were the subject of forbearance or repayment agreements are not included in the 40-68+ days delinquent categories, but were included in the cancelled contracts category.

	<u>1998<sup>(1)</sup></u>	<u>1999<sup>(1)</sup></u>
<b>Percentage of Number of Contracts of Purchase</b>		
<b>Delinquent<sup>(7)</sup></b>		
40-67 days .....	0.78%	0.87%
68+ days .....	1.99%	1.34%
Cancelled Contracts and Real Estate in inventory <sup>(4)</sup> ..	1.49%	0.94%

## Veterans G.O. Bonds and Revenue Bonds

The chart below sets forth certain information regarding Veterans G.O. Bonds and Revenue Bonds.

### Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds

<u>Series</u>	<u>Bonds Outstanding as of June 30, 2006</u>	<u>Expected Bonds Outstanding as of February 1, 2007</u>	<u>Final Maturity Date of Series as of February 1, 2007</u>	<u>Next Optional Call Date as of February 1, 2007</u>	<u>Call Price on Such Date</u>	<u>Maximum Coupon subject to Optional Call</u>	<u>Bonds Subject to Special Redemption<sup>(2)</sup></u>
<b>Veterans G.O. Bonds Issued as Qualified Veterans' Mortgage Bonds under the 1954 Code</b>							
AK .....	\$ 1,500,000	\$ 1,500,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AL .....	4,000,000	4,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AM .....	15,000,000	10,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AN .....	21,000,000	21,000,000	April 1, 2009	Non-callable	N.A.	N.A.	No
AP .....	10,500,000	10,500,000	April 1, 2009	Non-callable	N.A.	N.A.	No
AQ .....	31,500,000	21,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AR .....	21,000,000	20,000,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AS .....	26,000,000	22,000,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AT .....	82,615,000	63,705,000	February 1, 2010	Non-callable	N.A.	N.A.	No
AU .....	62,040,000	50,670,000	October 1, 2010	Non-callable	N.A.	N.A.	No
AV .....	42,220,000	34,355,000	October 1, 2010	Non-callable	N.A.	N.A.	No
Sub-total	<u>\$ 317,375,000</u>	<u>\$ 258,730,000</u>					
<b>Veterans G.O. Bonds and Notes Issued as Qualified Veterans' Mortgage Bonds under the 1986 Code</b>							
BG/BH <sup>(5)</sup> .....	\$ 359,775,000	\$ 208,560,000	December 1, 2016	December 1, 2008	101%	5.400%	Excess Revenues
BJ7 .....	2,875,000	2,855,000	December 1, 2012	December 1, 2009	101%	5.625%	Excess Revenues
BJ9 .....	6,510,000	6,500,000	December 1, 2016	April 27, 2010	101%	5.600%	Excess Revenues
BP <sup>(5)</sup> .....	5,130,000	2,220,000	December 1, 2026	Anytime	100%	5.500%	Excess Revenues
BR .....	48,630,000	48,630,000	December 1, 2029	Anytime	100%	5.300%	Excess Revenues
BS .....	1,000,000	1,000,000	December 1, 2008	Non-callable	N/A	N/A	Excess Revenues
BJ11/12 .....	56,330,000	56,290,000	December 1, 2032	-- <sup>(1)</sup>	-- <sup>(1)</sup>	5.700%	Excess Revenues
BT/BU <sup>(5)</sup> .....	76,630,000	21,265,000	December 1, 2015	Anytime	100%	5.100%	Excess Revenues
BV/BW <sup>(5)</sup> .....	30,635,000	7,150,000	December 1, 2013	Anytime	101%	5.150%	Excess Revenues
BX <sup>(5)</sup> .....	41,900,000	30,310,000	December 1, 2032	Anytime	101%	5.500%	Excess Revenues
BY/BZ .....	111,325,000	111,325,000	December 1, 2024	June 1, 2007	101%	5.375%	Excess Revenues
CA/CB .....	221,475,000	221,475,000	December 1, 2036	June 1, 2015	100%	5.050%	Excess Revenues
CC/CD .....	0	359,160,000	December 1, 2040	December 1, 2015	100%	4.600%	Excess Revenues/ Unexpended Proceeds
Sub-total	<u>\$ 962,215,000</u>	<u>\$ 1,076,740,000</u>					
Commercial Paper <sup>(4)</sup> .....	\$ 56,050,000	0	N/A	N/A	N/A	N/A	N/A <sup>(5)</sup>
<b>TOTAL VETERANS G.O. BONDS</b>	<b><u>\$ 1,335,640,000</u></b>	<b><u>\$ 1,335,470,000</u></b>					

<u>Series</u>	<u>Bonds Outstanding as of June 30, 2006</u>	<u>Expected Bonds Outstanding as of February 1, 2007</u>	<u>Final Maturity Date of Series as of February 1, 2007</u>	<u>Next Optional Call Date as of February 1, 2007</u>	<u>Call Price on Such Date</u>	<u>Maximum Coupon subject to Optional Call</u>	<u>Bonds Subject to Special Redemption<sup>(2)</sup></u>
<b>Revenue Bonds Issued as Qualified Mortgage Bonds under the 1986 Code</b>							
1997 A/B .....	\$ 18,545,000	\$ 18,140,000	December 1, 2028	December 1, 2008	101%	5.500%	Excess Revenues
1997 C .....	38,100,000	33,965,000	December 1, 2019	January 9, 2011	101%	5.500%	Excess Revenues
1998 A .....	<u>22,185,000</u>	<u>19,105,000</u>	December 1, 2019	December 1, 2008	101%	5.450%	Excess Revenues
Sub-total	\$ 78,830,000	\$ 71,210,000					
<b>Revenue Bonds Issued to Refund Bonds Issued Prior to Mortgage Subsidy Bond Tax Act of 1980</b>							
1999 A <sup>(6)</sup> .....	\$ 54,170,000	\$ 25,160,000	December 1, 2027	Anytime	100%	5.200%	Excess Revenues
1999 B <sup>(6)</sup> .....	86,085,000	43,210,000	December 1, 2028	Anytime	100%	5.200%	Excess Revenues
2001 A <sup>(6)</sup> .....	39,840,000	0	N/A	N/A	N/A	N/A	N/A
2002 A .....	117,200,000	117,200,000	December 1, 2027	June 1, 2012	101%	5.350%	Excess Revenues
2003 A-1, A-2 <sup>(3)</sup> .....	124,635,000	0	N/A	N/A	N/A	N/A	N/A
2003 A-3 <sup>(3)</sup> .....	0	92,000,000	December 1, 2028	November 30, 2011	101%	4.600%	Excess Revenues
2005 A .....	42,600,000	42,600,000	December 1, 2027	June 1, 2015	100%	4.800%	Excess Revenues
2006 A .....	<u>0</u>	<u>144,360,000</u>	December 1, 2028	November 30, 2011	101%	4.600%	Excess Revenues
Sub-total	\$ 464,530,000	\$ 464,530,000					
TOTAL REVENUE							
BONDS	<u><u>\$ 543,360,000</u></u>	<u><u>\$ 535,740,000</u></u>					
TOTAL ALL BONDS	<u><u>\$ 1,879,000,000</u></u>	<u><u>\$1,871,210,000</u></u>					

<sup>(1)</sup> The BJ-11/12 Serial Bonds maturing on December 1, 2011 through and including December 1, 2016 are subject to optional redemption on December 19, 2010, initially at 101% of the principal amount thereof, declining to par on and after December 19, 2011. The BJ-11/12 Term Bonds maturing on December 1, 2032 are subject to optional redemption on December 19, 2006, initially at 102% of the principal amount thereof, declining to par on and after December 19, 2008.

<sup>(2)</sup> Excess Revenues includes principal prepayments.

<sup>(3)</sup> The 2003 A-1 and A-2 Bonds were issued as variable rate bonds and, as part of the Fall 2006 Transactions, a portion of such bonds will become fixed rate bonds and be redesignated as 2003A-3 Bonds, and the balance of the 2003 A-1 and A-2 Bonds will be retired with the proceeds from the 2006A Bonds.

<sup>(4)</sup> Expected to be retired in whole with proceeds from the Veterans G.O. Bonds.

<sup>(5)</sup> Reflects partial redemption by the expected issuance of Series CC/CD as part of the Fall 2006 Transactions.

<sup>(6)</sup> Reflects full or partial redemption by the expected issuance of Series 2006A as part of the Fall 2006 Transactions.

### Additional Investments

In addition to the investments described above under "Contracts of Purchase--Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments," the following investments have been made or will be made with respect to moneys in the 1943 Fund and in the Bond Reserve Account which secures the Revenue Bonds. Additional moneys in various Funds and Accounts in the 1943 Fund have been invested in SMIF. Amounts invested in SMIF may be withdrawn and reinvested at any time.

<u>Bond Series</u>	<u>Account Designation<sup>(1)</sup></u>	<u>Amount (000s)</u>	<u>Investment Provider<sup>(1)</sup></u>	<u>Initial Investment Date</u>	<u>Investment Maturity Date</u>	<u>Interest Rate (%)</u>	<u>Bond Series</u>	<u>Account Designation<sup>(1)</sup></u>	<u>Amount (000s)</u>	<u>Investment Provider<sup>(1)</sup></u>	<u>Initial Investment Date</u>	<u>Investment Maturity Date</u>	<u>Interest Rate (%)</u>
1997/1998	Reserve	\$5,251 <sup>(7)</sup>	Societe Generale	3/26/98	12/1/28	5.75	BJ 7/8	Revenue/ Recycling	variable <sup>(6)</sup>	Bayerische Landesbank Girozentrale	12/1/99	12/1/32 <sup>(6)</sup>	6.06
1999 A/B	Reserve	\$9,817 <sup>(7)</sup>	Westdeutsche Landesbank Girozentrale	3/30/99	12/1/28	5.38	1991 A	Revenue/ Recycling	variable <sup>(6)</sup>	Bayerische Landesbank Girozentrale	12/1/99	12/1/32 <sup>(6)</sup>	6.06
1997 C	Reserve	\$5,733 <sup>(7)</sup>	Westdeutsche Landesbank Girozentrale	1/1/01	12/1/19	5.625	BJ 9/10	Revenue/ Recycling	variable <sup>(8)</sup>	Westdeutsche Landesbank Girozentrale	4/27/00	12/1/32 <sup>(8)</sup>	6.46
2002 A	Reserve	\$3,759 <sup>(7)</sup>	Bayerische Landesbank Girozentrale	3/6/02	12/1/27	5.38	BS	Revenue	variable <sup>(8)</sup>	Westdeutsche Landesbank Girozentrale	4/27/00	12/1/32 <sup>(8)</sup>	6.46
BG/BH/BK/BL	Revenue/ Recycling	variable <sup>(2)</sup>	Societe Generale	12/29/97	12/1/32	5.91	BJ 11/12	Revenue/ Recycling	variable <sup>(9)</sup>	Westdeutsche Landesbank Girozentrale	12/19/00	12/1/32 <sup>(9)</sup>	5.50
1997/1998	Revenue/ Restricted Recoveries	Variable	Societe Generale	3/26/98	12/1/28	5.91	BT/BU	Revenue/ Recycling	variable <sup>(10)</sup>	Westdeutsche Landesbank Girozentrale	12/19/00	12/1/26 <sup>(10)</sup>	5.50
BP	Revenue/ Recycling	variable <sup>(3)</sup>	Westdeutsche Landesbank Girozentrale	5/5/98	12/1/28	5.38	1997 C	Revenue/ Restricted Recoveries	variable <sup>(11)</sup>	Westdeutsche Landesbank Girozentrale	1/9/01	12/1/19	5.50
1999 A/B	Revenue/ Recycling	variable <sup>(4)</sup>	Bayerische Landesbank Girozentrale	3/30/99	12/1/28	5.30	BV/BW	Revenue/ Recycling	variable <sup>(12)</sup>	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 <sup>(12)</sup>	5.67
BQ/BR	Revenue/ Recycling	variable <sup>(5)</sup>	Westdeutsche Landesbank Girozentrale	4/28/99	12/1/29	5.37	2001 A	Revenue/ Recycling	variable <sup>(12)</sup>	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 <sup>(12)</sup>	5.67
							BX	Revenue/ Recycling	variable <sup>(12)</sup>	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 <sup>(12)</sup>	5.67

<sup>(1)</sup> Accounts are established in the resolutions authorizing the issuance of Revenue Bonds. All investments are investment agreements unless otherwise noted.

<sup>(2)</sup> Maximum permitted amount on deposit under investment agreement at any one time is \$250,000,000.

<sup>(3)</sup> Maximum permitted amount on deposit under investment agreement for all (BP) subaccounts is \$50,000,000.

<sup>(4)</sup> Maximum permitted amount on deposit under investment agreement for both subaccounts is \$75,000,000.

<sup>(5)</sup> Maximum permitted amount on deposit under investment agreement for both subaccounts is \$35,000,000.

<sup>(6)</sup> Maximum permitted amount on deposit under investment agreement for all (BJ 7/8 and 1991 A) subaccounts is \$25,000,000. Investment maturity date for the recycling subaccounts is December 1, 2009.

<sup>(7)</sup> As of June 30, 2006.

<sup>(8)</sup> Maximum permitted amount on deposit under investment agreement for all three (BJ 9/10, and BS) subaccounts is \$20,000,000. Investment maturity date for BJ-9/10 G.O. Bond Series Recycling Subaccount is June 1, 2010.

<sup>(9)</sup> Maximum permitted amount on deposit under investment agreement for both subaccounts is \$25,000,000. Investment maturity date for BJ-11/12 G.O. Bond Series Recycling Subaccount is December 1, 2010.

<sup>(10)</sup> Maximum permitted amount on deposit under investment agreement for both subaccounts is \$20,000,000. Investment maturity date for BT/BU G.O. Bond Series Recycling Subaccount is December 1, 2010.

<sup>(11)</sup> Maximum permitted amount on deposit under investment agreement for both subaccounts is \$97,130,000.

<sup>(12)</sup> Maximum permitted amount on deposit under investment agreement for all (BV/BW, 2001 A and BX) subaccounts is \$25,000,000. Investment maturity date for all (BV/BW, 2001 A and BX) recycling subaccounts is December 1, 2011.

## **APPENDIX C**

### **DTC AND THE BOOK-ENTRY SYSTEM**

The information concerning DTC and DTC's book-entry system has been obtained from sources that the State Treasurer believes to be reliable, but the State Treasurer and the Underwriters take no responsibility for the accuracy or completeness thereof.

DTC will act as securities depository for the Offered Veterans G.O. Bonds. The Offered Veterans G.O. Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully registered Offered Veterans G.O. Bond certificate will be issued for each maturity of the Offered Veterans G.O. Bonds in the aggregate principal amount of such maturity, and will be deposited with DTC. DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 2.2 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues and money market instruments from over 100 countries that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions, in deposited securities through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC, in turn, is owned by a number of Direct Participants of DTC and Members of the National Securities Clearing Corporation, Fixed Income Clearing Corporation and Emerging Markets Clearing Corporation (NSCC, FICC and EMCC, also subsidiaries of DTCC), as well as by the New York Stock Exchange, Inc., the American Stock Exchange, LLC, and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks, trust companies and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has Standard & Poor's highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com) and [www.dtc.org](http://www.dtc.org).

Purchases of the Offered Veterans G.O. Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Offered Veterans G.O. Bonds on DTC's records. The ownership interest of each actual purchaser of each Offered Veterans G.O. Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmation providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Offered Veterans G.O. Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners.

Beneficial Owners will not receive certificates representing their ownership interests in Offered Veterans G.O. Bonds, except in the event that use of the book-entry system for the Offered Veterans G.O. Bonds is discontinued.

To facilitate subsequent transfers, all Offered Veterans G.O. Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of Offered Veterans G.O. Bonds with DTC and their registration in the name of Cede & Co., or such other nominee, do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Offered Veterans G.O. Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Offered Veterans G.O. Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. The State Treasurer will not have any responsibility or obligation to such Direct Participants and Indirect Participants or the persons for whom they act as nominees with respect to the Offered Veterans G.O. Bonds.

Beneficial Owners of the Offered Veterans G.O. Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Offered Veterans G.O. Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Offered Revenue Bond documents. Beneficial Owners of the Offered Veterans G.O. Bonds may wish to ascertain that the nominee holding the Offered Veterans G.O. Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners.

Redemption notices shall be sent to DTC. If less than all of a maturity of a Series of the Offered Veterans G.O. Bonds is being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity of a Series to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Offered Veterans G.O. Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the State Treasurer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Offered Veterans G.O. Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Without limiting the generality of the foregoing, the State Treasurer and the Underwriters have no responsibility or liability for any aspects of the records relating to or payments made on account of beneficial ownership, or for maintaining, supervising or reviewing any records relating to beneficial ownership, or interests in the Offered Veterans G.O. Bonds.

Principal, premium and interest payments on the Offered Veterans G.O. Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the State Treasurer on payable dates in accordance with their respective holdings shown on DTC's records. Payments by Direct Participants and



Indirect Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name" and will be the responsibility of such Participant and not of DTC (nor its nominee), the State Treasurer, subject to any statutory and regulatory requirements as may be in effect from time to time. Payment of principal and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Trustee or the Department, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

The State Treasurer and the Underwriters cannot and do not give any assurances that DTC, Direct Participants, Indirect Participants or others will distribute payments with respect to the Offered Veterans G.O. Bonds received by DTC or its nominee as the registered owner, or any prepayment or other notices, to the Beneficial Owners, or that they will do so on a timely basis, or that DTC will serve and act in the manner described in this Official Statement.

If the State Treasurer determines not to continue the DTC book-entry only system, or DTC discontinues providing its services with respect to the Offered Veterans G.O. Bonds and the State Treasurer does not select another qualified security depository, the Trustee shall deliver physical Offered Veterans G.O. Bond certificates to the Beneficial Owners. The Offered Veterans G.O. Bonds may thereafter be transferred upon the books of the State Treasurer by the registered owners, in person or by authorized attorney, upon surrender of Offered Veterans G.O. Bonds at the Office of the State Treasurer in Sacramento, California, accompanied by delivery of an executed instrument of transfer in a form approved by the State Treasurer and upon payment of any charges provided for in the Resolutions. Certificated Offered Veterans G.O. Bonds may be exchanged for Offered Veterans G.O. Bonds of other authorized denominations of the same aggregate principal amount and maturity at the Office of the State Treasurer in Sacramento, California, upon payment of any charges provided for in the Resolutions.

According to DTC, the foregoing information with respect to DTC has been provided for informational purposes only and is not intended to serve as a representation, warranty or contract modification of any kind.

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**APPENDIX D**  
**SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES**

**STATE TREASURER'S DISCLOSURE CERTIFICATE**

The State Treasurer, on behalf of the State, executed a Continuing Disclosure Certificate (the "Treasurer's Disclosure Certificate") for the Offered Veterans G.O. Bonds. The following is a summary of the provisions of the Treasurer's Disclosure Certificate. Such summary is qualified by reference to the complete Treasurer's Disclosure Certificate, which is available from the Office of the State Treasurer.

**Definitions**

Defined terms used in the Treasurer's Disclosure Certificate and not otherwise defined therein have the meanings set forth elsewhere in this Official Statement:

**"Annual Report"** shall mean the Annual Report filed by the State Treasurer pursuant to, and as described in, the Treasurer's Disclosure Certificate.

**"Beneficial Owner"** shall mean any person which has or shares the power, directly or indirectly, to make investment decisions concerning ownership of Offered Veterans G.O. Bonds (including persons holding Offered Veterans G.O. Bonds through nominees, depositories or other intermediaries).

**"Central Post Office"** means the DisclosureUSA website maintained by the Municipal Advisory Council of Texas or any successor thereto, or any other organization or method approved by the staff or members of the Securities and Exchange Commission (the "SEC") as an intermediary through which issuers may, in compliance with the Rule, make filings required by this Disclosure Certificate.

**"Dissemination Agent"** shall mean the State Treasurer, acting in its capacity as Dissemination Agent under the Treasurer's Disclosure Certificate, or any successor Dissemination Agent designated in writing by the State Treasurer.

**"Holder"** shall mean any person listed on the registration books of the State Treasurer as the registered owner of Offered Veterans G.O. Bonds.

**"Listed Events"** shall mean any of the events listed below under "Reporting of Significant Events."

**"National Repository"** shall mean any Nationally Recognized Municipal Securities Information Repository certified by the Securities and Exchange Commission to be the recipient of information of the nature of the Annual Reports required by the Treasurer's Disclosure Certificate.

**"Official Statement"** shall mean the Official Statement relating to the Offered Veterans G.O. Bonds.

**"Repository"** shall mean each National Repository and the State Repository.

**"Rule"** shall mean Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as the same may be amended from time to time.

**"State"** shall mean the State of California.

**“State Repository”** shall mean any public or private repository or entity within the State created for the purpose of receiving information of the nature of the Annual Reports or reports of material events required by the Treasurer’s Disclosure Certificate and recognized as such by the Securities and Exchange Commission. As of the date of this Official Statement, there is no State Repository.

## **Annual Reports**

The State Treasurer on behalf of the State shall, not later than April 1 of each year in which the Offered Veterans G.O. Bonds are outstanding, commencing with the report for the 2005-06 Fiscal Year, provide an Annual Report consistent with the requirements of the Treasurer’s Disclosure Certificate (an “Annual Report”) to each Repository; provided that the audited financial statements of the State may be submitted separately from the balance of the Annual Report and later than the date required above for the filing of the Annual Report if they are not available by that date. The State Treasurer shall make a copy of any Annual Report available to any person who requests a copy at a cost not exceeding the reasonable cost of duplication and delivery. The State reserves the right to make this filing through the Central Post Office.

If in any year, the State Treasurer does not provide the Annual Report to each Repository by the time specified above, the State Treasurer shall instead file a notice with each Repository stating that the Annual Report has not been timely completed and, if known, stating the date by which the State Treasurer expects to file the Annual Report. Giving of a notice pursuant to this paragraph shall not excuse failure to file the Annual Report pursuant to the paragraph above.

The Annual Report shall contain or include by reference the following:

(1) The audited Basic Financial Statements of the State for the fiscal year ended on the previous June 30, prepared in accordance with generally accepted accounting principles promulgated to apply to government entities from time to time by the Governmental Accounting Standards Board. If the State’s audited financial statements are not available by the time the Annual Report is required to be filed pursuant to the Treasurer’s Disclosure Certificate, the Annual Report shall contain unaudited financial statements in a format similar to the financial statements contained in the applicable final Official Statement, and the audited financial statements shall be filed in the same manner as the Annual Report when they become available.

(2) Financial information relating to the State’s General Fund budget for the fiscal year ended on the previous June 30 and information concerning the State budget for the fiscal year in which the Annual Report is issued. Such information shall describe the sources of revenues, the principal categories of expenditures, and changes in fund balances, a summary of expected State revenues and budgeted expenditures, and significant assumptions relating to revenue and expenditure expectations, including updating the following tables which appear under the caption APPENDIX A – “THE STATE OF CALIFORNIA – CURRENT STATE BUDGET” in the applicable Official Statement:

### Tables Entitled

Statement of Revenues, Expenditures and Changes in Fund Balance – General Fund  
Major General Fund Revenue Sources and Expenditures

(3) Information concerning the total amount of the State's authorized and outstanding debt, long-term lease obligations and other long-term liabilities as of the end of the most recent June 30, which debt is supported by payments from the State's General Fund and which includes short-term debt. Such information shall include schedules of debt service for outstanding general obligation bonds and lease-purchase debt. This shall be accomplished by updating the following tables which appear under the caption APPENDIX A – "THE STATE OF CALIFORNIA – STATE DEBT TABLES" in the Official Statement.

Tables Entitled

Outstanding State Debt

Authorized and Outstanding General Obligation Bonds

General Obligation and Lease Revenue Bonds – Summary of  
Debt Service Requirements

Schedule of Debt Service Requirements for General Fund

Non-Self Liquidating Bonds – Fixed Rate

Schedule of Debt Service Requirements for General Fund

Non-Self Liquidating Bonds – Variable Rate

Schedule of Debt Service Requirements for Special Revenue Fund

Self Liquidating Bonds – Fixed Rate

Schedule of Debt Service Requirements for Special Revenue Fund

Self Liquidating Bonds – Variable Rate

Schedule of Debt Service Requirements for Enterprise Fund

Self Liquidating Bonds – Fixed Rate

Schedule of Debt Service Requirements for Lease-Purchase Debt

State Public Works Board and Other

Lease-Purchase Financing Outstanding Issues

State Agency Revenue Bonds and

Conduit Financing

The Annual Report may consist of one or more documents. Any or all of the items listed above may be included in the Annual Report by reference to other documents which have been filed by the State with each of the Repositories, including any final official statement (in which case such final official statement must also be available from the Municipal Securities Rulemaking Board). The State Treasurer shall clearly identify in the Annual Report each such document so included by reference.

## Reporting of Significant Events

The State Treasurer, on behalf of the State shall give, or cause to be given, prompt notice of the occurrence of any of the following events with respect to the Offered Veterans G.O. Bonds, if material:

1. principal and interest payment delinquencies;
2. non-payment related defaults;
3. modifications to rights of Bondholders;
4. optional, contingent or unscheduled bond calls;
5. defeasances;
6. rating changes;
7. adverse tax opinions or events affecting the tax-exempt status of the Offered Veterans G.O. Bonds;
8. unscheduled draws on debt service reserves reflecting financial difficulties;
9. unscheduled draws on credit enhancements reflecting financial difficulties;
10. substitution of credit or liquidity providers, or their failure to perform; or
11. release, substitution or sale of property securing repayment of the Offered Veterans G.O. Bonds.

The State Treasurer shall timely file a notice of the occurrence of a Listed Event, which is material under applicable federal securities laws, with the Municipal Securities Rulemaking Board and each Repository. The State notes that items 8, 9, 10 and 11 above are not applicable to the Offered Veterans G.O. Bonds.

The State reserves the right to make such filings through the Central Post Office.

## Other Provisions

*Termination of Reporting Obligation.* The State's obligations under the Treasurer's Disclosure Certificate shall terminate upon the maturity, legal defeasance, prior redemption or acceleration of all of the applicable outstanding Offered Veterans G.O. Bonds. If such termination occurs prior to the final maturity of the Offered Veterans G.O. Bonds, the State Treasurer shall give notice of such termination in the same manner as for a Listed Event.

*Dissemination Agent.* The State Treasurer may, from time to time, appoint or engage a Dissemination Agent to assist it in carrying out the obligations under the Treasurer's Disclosure Certificate, and may discharge any such Dissemination Agent, with or without appointing a successor Dissemination Agent. The Dissemination Agent shall not be responsible in any manner for the content of any notice or report prepared by the State Treasurer pursuant to Treasurer's Disclosure Certificate. If at any time there is not any other designated Dissemination Agent, the State Treasurer shall be the Dissemination Agent. The initial Dissemination Agent shall be the State Treasurer.

*Amendment; Waiver.* Notwithstanding any other provision of the Treasurer's Disclosure Certificate, the State Treasurer may amend or waive any provision of the Treasurer's Disclosure Certificate, provided that the following conditions are satisfied:

- (a) If the amendment or waiver relates to the provisions of the Treasurer's Disclosure Certificate dealing with the timing or content of the Annual Report or the giving of notice of Listed Events, it may only be made in connection with a change in circumstances that arises from a change

in legal requirements, change in law or change in the identity, nature or status of an obligated person with respect to Offered Veterans G.O. Bonds, or the type of business conducted;

(b) The undertaking, as amended or taking into account such waiver, would, in the opinion of nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the issuance of Offered Veterans G.O. Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) The amendment or waiver either (i) is approved by the Holders of sixty percent (60%) of Offered Veterans G.O. Bonds, or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Holders or Beneficial Owners of Offered Veterans G.O. Bonds. The State also may amend this Disclosure Certificate without approval by the Holders to the extent permitted by rule, order or other official pronouncement of the SEC.

*Additional Information.* Nothing in the Treasurer's Disclosure Certificate shall be deemed to prevent the State Treasurer from disseminating any other information, using the means of dissemination set forth in the Treasurer's Disclosure Certificate or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Listed Event, in addition to that which is required by the Treasurer's Disclosure Certificate. If the State Treasurer chooses to include any information in any Annual Report or notice of occurrence of a Listed Event in addition to that which is specifically required by the Treasurer's Disclosure Certificate, the State Treasurer shall not have any obligation to update such information or include it in any future Annual Report or notice of occurrence of a Listed Event.

*Beneficiaries.* The Treasurer's Disclosure Certificate shall inure solely to the benefit of the Holders and Beneficial Owners from time to time of Offered Veterans G.O. Bonds, and shall create no rights in any other person or entity (except the right of any Bondholder or Beneficial Owner to enforce the provisions of the Treasurer's Disclosure Certificate on behalf of the Bondholders). The Treasurer's Disclosure Certificate is not intended to create any monetary rights on behalf of any person based upon the Rule.

*Partial Invalidity.* If any one or more of the agreements or covenants or portions thereof required hereby to be performed by or on the part of the State Treasurer shall be contrary to law, then such agreement or agreements, such covenant or covenants or such portions thereof shall be null and void and shall be deemed separable from the remaining agreements and covenants or portions thereof and shall in no way affect the validity hereof, and the Holders of the Bonds shall retain all the benefits afforded to them hereunder. The State Treasurer hereby declares that he would have executed and delivered this Disclosure Certificate and each and every other article, section, paragraph, subdivision, sentence, clause and phrase hereof irrespective of the fact that any one or more articles, sections, paragraphs, subdivisions, sentences, clauses or phrases hereof or the application thereof to any person or circumstance may be held to be unconstitutional, unenforceable or invalid.

*Governing Law.* The laws of the State of California shall govern this Disclosure Certificate, the interpretation thereof and any right or liability arising hereunder. Any action or proceeding to enforce or interpret any provision of this Disclosure Certificate shall be brought, commenced or prosecuted in Sacramento County, California.

### DEPARTMENT'S DISCLOSURE CERTIFICATE

The Secretary of Veterans Affairs (the "Secretary"), on behalf of the Department, executed a Continuing Disclosure Certificate (the "Department's Disclosure Certificate") for the Offered Veterans G.O. Bonds. The following is a summary of the Department's Disclosure Certificate. Such summary is qualified by reference to the complete Department's Disclosure Certificate, which are available from the Department.

#### **Certain Definitions**

Defined terms used in the Department's Disclosure Certificate and not otherwise defined therein have the meanings set forth elsewhere in this Official Statement.

**"Annual Financial Information"** means, collectively, (1) financial information or operating data applicable to the Department's most recent Fiscal Year on and after the fiscal year ending on or after June 30, 2005 of the types included in this Official Statement in EXHIBIT 2 to APPENDIX B thereto, and (2) the information regarding amendments to the Department's Disclosure Certificate required pursuant the Department's Disclosure Certificate. Annual Financial Information shall include Audited Financial Statements, if available, or Unaudited Financial Statements.

**"Audited Financial Statements"** means annual financial statements, if any, of the 1943 Fund, audited by such auditor as shall then be required or permitted by State law. Audited Financial Statements shall be prepared in accordance with GAAP applied on a consistent basis; *provided, however*, that the Department may from time to time, in order to comply with federal or State legal requirements, modify the basis upon which its financial statements are prepared. Notice of any such modification shall be provided to (i) the Trustee, (ii) either each NRMSIR or the MSRB, and (iii) the SID, and shall include a reference to the specific federal or State law or regulation describing such accounting basis.

**"Beneficial Owner"** means a beneficial owner of Subject Bonds, as determined pursuant to the Rule.

**"Bonds"** means, at any time, all of the State's then outstanding Offered Veterans G.O. Bonds, collectively.

**"Fiscal Year"** means that period established by the Department with respect to which its, as applicable, Audited Financial Statements or Unaudited Financial Statements are prepared. As of the date of the Department's Disclosure Certificate, the Department's Fiscal Year begins on July 1 and ends on June 30 of the next calendar year.

**"GAAP"** means generally accepted accounting principles as prescribed from time to time by the Financial Accounting Standards Board.

**"Holders"** means the registered owners of the Subject Bonds.

**"MSRB"** means the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934, as amended.

**"Notice"** means written notice, sent for overnight delivery via the United States Postal Service or a private delivery service which provides evidence of delivery.



**“Notice Address”** means with respect to the Department:

State of California Department of Veterans Affairs of the State of California  
1227 O Street  
Sacramento, CA 95814  
Attention: Bond Finance Division

**“NRMSIR”** means, at any time, a then-existing nationally recognized municipal securities information repository, as recognized from time to time by the SEC for the purposes referred to in the Rule.

**“Official Statement”** means the Official Statement relating to the issuance of the Subject Bonds.

**“Rule”** means the applicable provisions of Rule 15c2-12 promulgated by the SEC under the Securities Exchange Act of 1934, as amended (17 CFR Part 240, § 240.15c2-12), as in effect on the date of the Department’s Disclosure Certificate, including any official interpretations thereof.

**“SEC”** means the United States Securities and Exchange Commission.

**“Securities Counsel”** means legal counsel expert in federal securities law.

**“SID”** means, at any time, a then-existing state information depository, if any, as operated or designated as such by or on behalf of the State of California and recognized by the SEC for the purposes referred to in the Rule.\*

**“Subject Bonds”** means the Offered Veterans G.O. Bonds and those Veterans G.O. Bonds subject to the same Department’s Disclosure Certificate.

**“Unaudited Financial Statements”** means the same as Audited Financial Statements, except that they shall not have been audited.

**“Underwriters”** means the respective underwriters in connection with the offering of the Subject Bonds.

### **Provision of Annual Financial Information**

The Department shall provide Annual Financial Information with respect to each Fiscal Year to the State Treasurer and to each NRMSIR and the SID, by no later than the first day of the tenth calendar month after the end of such Fiscal Year.

The Department’s Disclosure Certificate requires the Department to provide, in a timely manner, notice of any failure by it to provide Annual Financial Information to each NRMSIR and the SID on or before the date described in the first paragraph under this heading, to the SID, to the State Treasurer, and to either (i) each NRMSIR or (ii) the MSRB.

Annual Financial Information shall be provided at least annually, *notwithstanding* any Fiscal Year longer than 12 calendar months. The Department shall promptly notify the State Treasurer, the SID and either (i) each NRMSIR or (ii) the MSRB, of each change in its Fiscal Year.

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\* As of the date of this Official Statement, there is no SID.

It shall be sufficient for purposes of Department's Disclosure Certificate if the Department provides Annual Financial Information by specific reference to documents previously either (i) provided to each NRMSIR existing at the time of such reference and the SID or (ii) filed with the SEC. If such a document is a final official statement within the meaning of the Rule, it also must be available from the MSRB.

Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time.

If not provided as part of the Annual Financial Information by the date required, the Department shall provide Audited Financial Statements, when and if available, to the State Treasurer and to each NRMSIR and the SID.

#### **Additional Disclosure Obligations.**

The Department acknowledges in the Department's Disclosure Certificate that other state and federal laws, including but not limited to the Securities Act of 1933 and Rule 10b-5 promulgated under the Securities Exchange Act of 1934, may apply to the Department, and that under some circumstances compliance with the Department's Disclosure Certificate, without additional disclosures or other action, may not fully discharge all duties and obligations of the Department under such laws.

#### **Additional Information**

Nothing in the Department's Disclosure Certificate will be deemed to prevent the Department from disseminating any other information, using the means of dissemination set forth in such Department's Disclosure Certificate or any other means of communication, or including any other information in any Annual Financial Information, in addition to that which is required by the Department's Disclosure Certificate. If the Department chooses to include any information in any Annual Financial Information in addition to that which is specifically required by the Department's Disclosure Certificate, the Department shall have no obligation under the Department's Disclosure Certificate to update such information or include it in any future Annual Financial Information.

#### **Termination of Reporting Obligation**

The Department's obligations under the Department's Disclosure Certificate with respect to the Subject Bonds terminate upon the legal defeasance, prior redemption, or payment in full of all of such Subject Bonds. The Department shall give notice of any such termination to the SID and to either each NRMSIR or the MSRB.

Department's Disclosure Certificate, or any provision thereof, shall be null and void to the extent set forth in an opinion of Securities Counsel obtained by the Department, and addressed to the Department and the State Treasurer, to the effect that those portions of the Rule which require the provisions of the Department's Disclosure Certificate, or any of such provisions, do not or no longer apply to any or all of the Subject Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as shall be specified in such opinion, and delivers notice to such effect to the State Treasurer, to the SID and to either each NRMSIR or the MSRB.

#### **Amendment of Department's Disclosure Certificate**

The Department's Disclosure Certificate may be amended and any provision of the Department's Disclosure Certificate be waived, without the consent of the Holders or Beneficial

Owners, except as described in clause 4 (ii) below, under the following conditions: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature or status of the Department or the type of business conducted thereby, (2) the Department's Disclosure Certificate as so amended or waived would have complied with the requirements of the Rule as of the date of each primary offering of Subject Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Department shall have obtained an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Department (such as bond counsel), acceptable to the Department, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the applicable Holders consent to the amendment to or waiver of such Department's Disclosure Certificate, and (5) the Department shall have delivered copies of such amendment or waiver to the SID, to the State Treasurer, and to either each NRMSIR or the MSRB.

In addition to the foregoing, the Department may amend the Department's Disclosure Certificate, and any provision of the Department's Disclosure Certificate may be waived, if the Department shall have received an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the effect that the adoption and the terms of the amendment or waiver would not, in and of themselves, cause the undertakings in such Department's Disclosure Certificate to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule.

To the extent any amendment to the Department's Disclosure Certificate results in a change in the type of financial information or operating data provided pursuant to the Department's Disclosure Certificate, the first Annual Financial Information provided thereafter shall include a narrative explanation of the reasons for the amendment, and the impact of the change.

If a change is made to the basis on which financial statements are prepared, the Annual Financial Information for the year in which the change is made shall present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles. Such comparison shall include a qualitative and, to the extent reasonably feasible, quantitative discussion of the differences in the accounting principles and the impact of the change in the accounting principles on the presentation of the financial information.

### **Benefit; Third-Party Beneficiaries; Enforcement**

The provisions of the Department's Disclosure Certificate shall inure solely to the benefit of the Holders from time to time; *except* that Beneficial Owners shall be third-party beneficiaries of the Department's Disclosure Certificate.

Except as described in this paragraph, the provisions of the Department's Disclosure Certificate shall create no rights in any other person or entity. Except as limited by the succeeding sentence, the obligation of the Department to comply with the provisions of the Department's Disclosure Certificate shall be enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data, and notices, by any Beneficial Owner of outstanding Subject Bonds, or (ii) in the case of challenges to the adequacy of the financial

statements, financial information and operating data so provided, by the Holder of not less than 25% in aggregate principal amount of the Subject Bonds at the time outstanding.

The right to enforce the provisions of the Department's Disclosure Certificate shall be limited to a right, by action in mandamus or for specific performance, to compel performance of the Department's obligations under the Department's Disclosure Certificate. Any failure by the Department to perform in accordance with the shall not constitute a default or any Event of Default under the Subject Bonds, and the rights and remedies provided by the Subject Bonds upon the occurrence of a default or an Event of Default shall not apply to any such failure.

### **Governing Law**

The Department's Disclosure Certificate will be construed and interpreted in accordance with the laws of the State, and any suits and actions arising out of the Department's Disclosure Certificate will be instituted in a court of competent jurisdiction in the State, *provided that*, to the extent such Department's Disclosure Certificate address matters of federal securities laws, including the Rule, the Department's Disclosure Certificate will be construed in accordance with such federal securities laws and official interpretations thereof.

## **APPENDIX E**

### **CERTAIN FEDERAL TAX CODE REQUIREMENTS**

The Federal Tax Code restricts the issuance of Federally tax-exempt bonds to finance mortgage loans for single family housing or to refund such bonds.

Those Federal Tax Code restrictions are not the same for all such tax-exempt bonds. There are three types of such tax-exempt bonds: (i) qualified mortgage bonds, which provide Qualified Mortgage Bond Proceeds, (ii) qualified veterans' mortgage bonds, which provide QVMB Proceeds, and (iii) Pre-Ullman bonds, which provide Unrestricted Moneys. Revenue Bonds may be either qualified mortgage bonds or Pre-Ullman bonds. ("Pre-Ullman bonds" are bonds issued before 1981, or bonds issued to refund such bonds.) Veterans G.O. Bonds may be either qualified veterans' mortgage bonds or Pre-Ullman bonds. The principal Federal Tax Code restrictions relate to: (i) the use of proceeds of the bond issue, (ii) the yield on the financed mortgage loans and from certain non-mortgage investments related to the issue, (iii) for qualified mortgage bonds and qualified veterans' mortgage bonds, loan eligibility requirements, (iv) for qualified mortgage bonds, the availability of proceeds of the issue for financing housing located in "targeted areas," and (v) certain matters relating to the issue itself.

See "TAX MATTERS" for information regarding the requirements applicable to the Offered Veterans G.O. Bonds.

Failure to comply with the applicable provisions of the Federal Tax Code may result in interest on the applicable issue of bonds being included in gross income for federal income tax purposes retroactive to the date of issuance thereof.

#### ***Loan Eligibility Requirements Imposed by the Federal Tax Code on Qualified Mortgage Bond Proceeds and QVMB Proceeds***

##### **Qualified Mortgage Bond Proceeds**

The Federal Tax Code contains the following loan eligibility requirements with respect to Qualified Mortgage Bond Proceeds, except that the requirements described under "First-Time Homebuyer Requirement," "Purchase Price Limitation," and "Other Requirements Imposed by the Code – Recapture Provision Applicable to Qualified Mortgage Bonds" do not apply to home improvement loans, and the requirements described under "Qualified Home Improvement Loans" do not apply to loans for the acquisition of single family homes. None of those requirements applies to Pre-Ullman bonds or qualified veterans' mortgage bonds.

**Residence Requirement.** The Federal Tax Code requires that each of the premises financed with the lendable proceeds of qualified mortgage bonds be a one-to-four-family residence, one unit of which can reasonably be expected to become the principal residence of the veteran within a reasonable time after the financing is provided. Certain documents adopted by the Department establish procedures to be followed in connection with Contracts of Purchase which finance the acquisition of single family homes in order to assure that interest paid on the qualified mortgage bonds not be included in gross income for Federal income tax purposes under the Federal Tax Code (the "Single Family Program Documents"). Certain documents adopted by the Department establish procedures to be followed in connection with Contracts of Purchase to finance home improvement loans intended to assure that interest paid on the qualified mortgage bonds is not included in gross income for Federal income tax purposes under the Federal Tax Code (the "Home Improvement Program Documents," together with the Single Family Program

Documents, the “Program Documents”). In connection with the financing of a Contract of Purchase, the Program Documents require that each veteran submit an affidavit stating such person’s intention to occupy the premises as his principal residence within 60 days after closing of the Contract of Purchase.

First-Time Homebuyer Requirement. The Federal Tax Code requires that, subject to certain exceptions, the lendable proceeds of qualified mortgage bonds be used to provide financing to borrowers who have not had a present ownership interest in their principal residence during the three-year period prior to execution of the mortgage loan. All financing with respect to targeted area residences and residences on land possessed under certain contract for deed agreements is treated as satisfying the first time homebuyer requirement. Veterans subject to this requirement are required to provide federal income tax returns for the previous three years or other appropriate certifications to allow verification that no deductions or other entries have been made that would indicate any such ownership interest.

New Mortgage Requirement. The Federal Tax Code requires that, with certain limited exceptions, the lendable proceeds of qualified mortgage bonds finance new mortgage loans only and that no proceeds may be used to acquire or replace an existing mortgage loan, which would include the refinancing of a pre-existing mortgage loan. The Program Documents state that the Department will verify compliance with the new mortgage requirement by requiring each veteran to certify prior to financing, subject to such exceptions, that no refinancing of a prior mortgage loan is being effected.

Purchase Price Limitation. The Federal Tax Code requires that the purchase price of the residence financed with the lendable proceeds of qualified mortgage bonds may not exceed 90% of the average area purchase price applicable to such residence or 110% of the applicable average area purchase price in the case of residences located in targeted areas. The Program Documents state that the Department will verify compliance with the purchase price limitations by requiring each veteran and seller of a residence to make certifications regarding the purchase price of such residence.

Income Limitation. The Federal Tax Code requires that all mortgage loans made from the lendable proceeds of qualified mortgage bonds be made only to borrowers whose family income does not exceed 115% (for mortgage loans made to families with fewer than three members, 100%) of the applicable median family income. An exception is provided for mortgage loans financed with the lendable proceeds of qualified mortgage bonds made with respect to targeted area residences that permits two-thirds in aggregate amount of such mortgage loans to be made with respect to borrowers whose family income does not exceed 140% (for mortgage loans made to families with fewer than three members, 120%) of the applicable median family income and one-third in aggregate amount of such loans to be made without regard to any income limitation.

Federal tax law permits higher income limits for persons financing homes located in certain “high housing cost areas.” A high housing cost area is a statistical area for which the ratios of the area’s average purchase price for existing and new single family houses to the area’s median income exceed 120% of the same ratios determined on a national basis. These ratios are determined separately with respect to new and existing single family residences. An area is a high housing cost area only if the ratios for both new and existing houses meet the 120% test. In high housing cost areas, the veteran income limits are increased above 115% (or 100%, as

applicable) by one percent for each percentage point (1%) by which the new or existing housing price ratio, whichever is smaller, exceeds 120%. However, the new limit cannot exceed 140% (or 120%, as applicable) of the income limits otherwise applicable. Certain areas of the State may qualify as high housing cost areas.

Family income includes income of all individuals executing both the note and mortgage and occupying the dwelling as their principal residence.

Requirements as to Assumptions. The Federal Tax Code provides that a mortgage loan may be assumed only if each of the then applicable residence requirements, first-time-homebuyer requirement, purchase price limitation, and income limitation is met with respect to such assumption. The Contracts of Purchase contain a “due on sale” clause, and the Program Documents state that the assumption of a Contract of Purchase should not be permitted unless these requirements have been met and the appropriate certifications have been obtained.

Qualified Home Improvement Loans. The Federal Tax Code requires that a home improvement loan financed with the lendable proceeds of qualified mortgage bonds not exceed \$15,000, be made only with respect to an owner-occupied residence, and finance alterations, repairs, and improvements on or in connection with an existing one-to-four-family residence by the owner thereof, but only if such alterations, repairs and improvements substantially protect or improve the basic livability or energy efficiency of the property.

General. Qualified mortgage bonds treated under the Federal Tax Code as one bond issue for federal tax purposes (“qualified mortgage issue”) are deemed to meet the loan eligibility requirements of the Federal Tax Code if (i) the issuer in good faith attempted to meet all the loan eligibility requirements before the mortgage loans were executed, (ii) any failure to comply with the loan eligibility requirements is corrected within a reasonable period after such failure is first discovered, and (iii) 95% or more of the proceeds of the issue used to make mortgage loans was used to finance residences that met all such requirements at the time the mortgage loans were executed. In determining whether 95% or more of the proceeds has been so used, the Federal Tax Code permits the Department to rely on an affidavit of the veteran and of the seller as to the purchase price of a residence and an affidavit of the veteran and an examination of copies of the veteran’s Federal income tax returns for the last three years preceding the date the Contract of Purchase is or was executed even though the relevant information in such affidavits and income tax returns should ultimately prove to be untrue, unless the Department knows or has reason to believe that such information is false.

#### QVMB Proceeds

The Federal Tax Code requires that each mortgagor to whom financing is provided under a qualified veterans’ mortgage bond issue have served on active duty at some time before January 1, 1977 and apply for financing before the later of January 31, 1985 or the date which is 30 years after the last date on which the veteran left active service. The Department has established and has covenanted to comply with such requirements.

Generally, only the loan eligibility requirements stated above under “Qualified Mortgage Bond Proceeds – Residence Requirement,” “– New Mortgage Requirement” and “– Qualified Home Improvement Loans” (*except* the \$15,000 maximum loan amount) apply to QVMB Proceeds.

### ***Other Requirements Imposed by the Federal Tax Code***

General. The Federal Tax Code provides that gross income for federal income tax purposes does not include interest on a mortgage revenue bond if it is a qualified mortgage bond or a qualified veterans' mortgage bond. A qualified mortgage bond is a part of an issue of a state or political subdivision all the proceeds of which (net of amounts applied to any costs of issuance thereof and to fund a reasonably required reserve) are used to finance (or to refund bonds all of such net proceeds of which were used to finance) owner-occupied residences and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code." A qualified veterans' mortgage bond is part of an issue 95 percent or more of the net proceeds of which are used to provide residences to veterans and that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code."

Volume Limitation, Targeted Area and Required Reports. The first general requirement of the Federal Tax Code, applicable to qualified mortgage bonds, is that the aggregate amount of private activity bonds (exclusive of qualified veterans' mortgage bonds) that may be issued by the Department in any calendar year (or previous years' carried forward amount) must not exceed the portion of the private activity bond volume limit for the State for such calendar year that is allocated by the State to the Department. With respect to qualified veterans' mortgage bonds, a separate limit is based on statutory formulae. The second general requirement of the Federal Tax Code applicable to qualified mortgage bonds is that at least 20% of the lendable proceeds of an issue of bonds which are not refunding bonds (if such set-aside was satisfied with respect to the bonds being refunded) must be made available (and applied with reasonable diligence) for owner-financing of residences in targeted areas (as defined by the Federal Tax Code) for at least one year after the date on which such funds are first available for such owner-financing (the "targeted area requirement"). The third general requirement of the Federal Tax Code requires the issuer of qualified mortgage bonds and qualified veterans' mortgage bonds to file with the Internal Revenue Service reports on the issuance of its qualified mortgage bonds or qualified veterans' mortgage bonds following such issuance, as well as an annual qualified mortgage loan information report.

Yield Limitations and Rebate. The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds may not exceed the yield on the issue by more than 1.125% (1.50% for Pre-Ullman bonds), and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans. These requirements apply to both Revenue Bonds and Veterans G.O. Bonds, except that for Veterans G.O. Bonds, rebate, absent an election to pay to the United States, is to veterans. The Department has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See APPENDIX B – "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND" and "–THE PROGRAM – CONTRACTS OF PURCHASE" for discussions of provisions of the Veterans



Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

Recapture Provision Applicable to Qualified Mortgage Bonds. For certain mortgage loans made after December 31, 1990 from the lendable proceeds of qualified mortgage bonds issued after August 15, 1986 (not including the Offered Veterans G.O. Bonds), and for assumptions of such mortgage loans, the Federal Tax Code requires a payment to the United States from certain borrowers upon sale or other disposition of their homes (the "Recapture Provision"). The Recapture Provision requires that an amount determined to be the subsidy provided by a qualified mortgage bond financing to a borrower be paid to the United States on disposition of the residence (but not in excess of 50% of the gain realized by the borrower). The recapture amount would (i) increase over the period of ownership, with full recapture occurring if the residence were sold between four and five full years after the closing of the mortgage loan and (ii) decline ratably to zero with respect to sales occurring between five and nine full years after the closing of the mortgage loan. An exception excludes from recapture part or all of the subsidy in the case of certain assisted individuals whose incomes are less than prescribed amounts at the time of the disposition. The Federal Tax Code requires an issuer to inform borrowers of certain information with respect to the Recapture Provision. The Program Documents include a form of notice and establish procedures to send such notice.

Required Redemptions. For qualified mortgage bonds issued after 1988, the Federal Tax Code permits repayments (including prepayments) of principal of mortgage loans financed with the proceeds of an issue of such bonds to be used to make additional mortgage loans for only 10 years from the date of issuance of the bonds (or the date of issuance of the original bonds in the case of refundings), after which date such amounts must be used to redeem bonds, except for a \$250,000 *de minimis* amount. As a result, the Department is required by the Federal Tax Code to redeem Revenue Bonds which are qualified mortgage bonds from repayments (including prepayments) of principal of certain Contracts of Purchase not later than the close of the semi-annual period after the payment is received.

Compliance. The Federal Tax Code states that an issuer will be treated as meeting the targeted area requirement, the arbitrage restrictions on mortgage loans, and the recapture information requirements if it in good faith attempted to meet all such requirements and any failure to meet such requirements was due to inadvertent error after taking all reasonable steps to comply with such requirements.

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**APPENDIX F**  
**PROPOSED FORM OF LEGAL OPINION OF ATTORNEY GENERAL**

[closing date]

The Honorable Philip Angelides  
State Treasurer  
Sacramento, California

**\$359,160,000**  
**State of California**  
**Veterans General Obligation Bonds**

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**Final Opinion**

Honorable Philip Angelides:

We have acted as counsel to the State of California (the “State”) in connection with the issuance by the State of \$359,160,000 aggregate principal amount of State of California Veterans General Obligation Bonds, dated November 21, 2006, issued as two separate series under five bond acts, all identified in Schedule A hereto, which is incorporated by reference (collectively, the “Bonds”). The Bonds are authorized pursuant to (i) the respective veterans bond acts identified in Schedule A (collectively, the “Bond Acts”), (ii) Part 3 of Division 4 of Title 2 of the California Government Code and (iii) to resolutions adopted by the Veterans Finance Committee of 1943 on March 28, 2006 and September 20, 2006, identified in Schedule B hereto, which is incorporated by reference (the “Resolutions”).

In such connection, we have examined the record of proceedings submitted to us relative to the issuance of the Bonds, including the Resolutions, certifications of the State, and such other documents and matters deemed necessary by us to render the opinions set forth herein, although in doing so, we have not undertaken to verify independently the accuracy of the factual matters represented, warranted or certified therein, and we have assumed the genuineness of all signatures thereto.

The opinions expressed herein are based upon an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof.

We have neither undertaken to determine, nor to inform any person, whether any such actions are taken or omitted or events do occur or whether any other matters come to our attention after the date hereof. Furthermore, we have assumed compliance with the agreements and covenants contained in the Resolutions. We call attention to the fact that the rights and obligations under the Bonds and the Resolutions may be subject to bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors’ rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases, and to the limitations contained in State law regarding legal remedies against the State. We express no opinion as to whether interest on the Bonds is

excluded from gross income for federal income tax purposes or exempt from State of California personal income taxes or as to any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Bonds. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement dated November 9, 2006, or other offering material relating to the Bonds and express no opinion with respect thereto.

Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the opinion that the State has lawful authority for the issuance of the Bonds, and the Bonds constitute the valid and binding general obligations of the State payable in accordance with the Bond Acts from the General Fund of the State. The full faith and credit of the State of California are pledged to the punctual payment of the principal of and interest on the Bonds, as the principal and interest become due and payable.

Sincerely,

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Deputy Attorney General

For     BILL LOCKYER  
         Attorney General

## **Schedule A**

### **\$155,350,000 Series CC**

1. \$200,000 principal amount of State of California Veterans General Obligation Bonds, Series CC1, authorized under the Veterans Bond Act of 1988.
2. \$34,875,000 principal amount of State of California Veterans General Obligation Bonds, Series CC2, authorized under the Veterans Bond Act of 1996.
3. \$120,275,000 principal amount of State of California Veterans General Obligation Bonds, Series CC3, authorized under the Veterans Bond Act of 2000.

### **\$203,810,000 Series CD**

1. \$19,280,000 principal amount of State of California Veterans General Obligation Bonds, Series CD1, authorized under the Veterans Bond Act of 1986.
2. \$34,525,000 principal amount of State of California Veterans General Obligation Bonds, Series CD2, authorized under the Veterans Bond Act of 1988.
3. \$64,595,000 principal amount of State of California Veterans General Obligation Bonds, Series CD3, authorized under the Veterans Bond Act of 1990.
4. \$85,410,000 principal amount of State of California Veterans General Obligation Bonds, Series CD4, authorized under the Veterans Bond Act of 1996.

## Schedule B

<b><u>Bond Act</u></b>	<b><u>Resolution Number</u></b>	<b><u>Date of Adoption by Veterans Finance Committee Resolution</u></b>
Veterans Bond Act of 1986	XVII	March 28, 2005
Veterans Bond Act of 1988	X	March 28, 2005
Veterans Bond Act of 1990	X	March 28, 2005
Veterans Bond Act of 1996	V	March 28, 2005
Veterans Bond Act of 1996	VI	September 20, 2006
Veterans Bond Act of 2000	I	March 28, 2005

**APPENDIX G**  
**PROPOSED FORM OF LEGAL OPINION OF BOND COUNSEL TO THE STATE**

[Closing Date]

Office of the Treasurer of the State  
of California  
915 Capitol Mall, Room 235  
Sacramento, California 95814

Ladies and Gentlemen:

We have acted as bond counsel to the State of California (the “State”), and in such capacity we have examined upon request copies of proceedings taken by the State in connection with the issuance of the State’s \$155,350,000 aggregate principal amount Veterans General Obligation Bonds, Series CC (the “Series CC Bonds”) and \$203,810,000 aggregate principal amount Veterans General Obligation Bonds, Series CD (the “Series CD Bonds,” and together with the Series CC Bonds, the “Series CC and CD Bonds”) and the sale of the Series CC and CD Bonds to the initial purchasers thereof. The Series CC and CD Bonds are issued pursuant to (i) the Veterans Bond Acts identified in Schedule A hereto (collectively the “Law”), which is incorporated by reference, each of which was approved by the electors of the State, (ii) Part 3 of Division 4 of Title 2 of the California Government Code, and (iii) resolutions (the “Resolutions”) adopted by the Veterans Finance Committee of 1943 on March 18, 2005 and September 20, 2006, identified in Schedule B hereto, which is incorporated by reference.

The Series CC and CD Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, and are payable as provided in the Resolutions. The Series CC and CD Bonds are subject to redemption prior to maturity in whole or in part as provided in the Resolutions.

The Department of Veterans Affairs of the State of California (the “Department”) intends to issue its Home Purchase Revenue Bonds, 2006 Series A (the “2006 Revenue Bonds”) on the date hereof. The Series CC and CD Bonds and the 2006 Revenue Bonds are treated as a single issue for certain federal tax purposes under the Internal Revenue Code of 1986, as amended (the “Code”). Applicable federal tax law establishes certain requirements that must be met subsequent to the issuance of the Series CC and CD Bonds and the 2006 Revenue Bonds in order that interest on the Series CC and CD Bonds not be included in gross income for Federal income tax purposes under the Code. The Department has adopted documents with respect to its program (the “Program Documents”) that establish procedures under which, if followed, such requirements can be met. The State and the Department have covenanted in the Resolutions and in tax certificates and other documents applicable to the issuance of the Series CC and CD Bonds and the 2006 Revenue Bonds (collectively with the Program Documents, the “Documents”), to at all times perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Series CC and CD Bonds shall not be included in gross income for federal income tax purposes under the Code. In rendering this opinion, we have relied upon such covenants and have assumed compliance by the State and the Department with the provisions of such Documents.

In connection with the issuance of the Series CC and CD Bonds, we have examined (a) a copy of the Resolutions, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(1) The State has lawful authority for the issuance of the Series CC and CD Bonds, and the Series CC and CD Bonds constitute the valid and legally binding general obligations of the State payable in accordance with the Law from the General Fund of the State. The full faith and credit of the State of California are pledged for the punctual payment of the principal of and interest on the Series CC and CD Bonds.

(2) Under existing statutes and court decisions and assuming compliance with certain tax covenants described herein, (i) interest on the Series CC and CD Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Code, and (ii) interest on the Series CC Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations. Interest on the Series CD Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code. No opinion as to exclusion from gross income of interest on any of the Bonds is expressed subsequent to any date on which action is taken pursuant to the Resolutions for which action the Resolutions require a legal opinion to the effect that taking such action will not adversely affect such exclusion, should the undersigned not deliver an opinion as of such date to such effect.

(3) Interest on the Series CC and CD Bonds is exempt from State personal income taxation under present State law.

In rendering this opinion, we express no opinion regarding any other Federal or state tax consequences with respect to the Series CC and CD Bonds. We render this opinion under existing statutes and court decisions as of the issue date, and assume no obligation to update this opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation, or otherwise. In rendering this opinion, we express no opinion on the effect of any action taken after the date of the opinion or not taken in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Series CC and CD Bonds, or under state and local tax law. We undertake no responsibility for the accuracy, completeness or fairness of any official statement or other offering materials relating to the Bonds and express herein no opinion relating thereto.

In rendering this opinion, we are advising you that the enforceability of the Series CC and CD Bonds may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

Very truly yours,



## **Schedule A**

### **\$155,350,000 Series CC**

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